The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2014 (Second Report)

House of Representatives
Standing Committee on Economics

November 2015
Canberra

ISBN 978-1-74366-394-3 (Printed Version)
ISBN 978-1-74366-395-0 (HTML Version)

Chair's foreword

On 1 September 2015 the RBA decided to leave official interest rates at 2.0 per cent following the most recent rate cut in May 2015. The Governor commented that accommodative monetary policy was appropriate in the current circumstances and the economic and financial conditions over the period ahead will inform the RBA as to whether the current policy will most effectively foster sustainable growth and inflation in line with the target.

At the public hearing on 18 September 2015 the Governor noted that the Australian economy is progressing through a major adjustment, with terms of trade declining by a third and reaching 2006 levels. Investment in the resource sector is about halfway through its decline and will likely fall to about five per cent of GDP from its peak of about eight per cent. In comparison, some of the non-mining sectors have shown significant improvements over the last 12 months and the Governor was optimistic about the Australian economy noting GDP growth was likely to exceed three per cent by June 2017.

Current labour conditions have generally been better than expected with unemployment likely to remain unchanged for about 18 months before declining in 2017. While there is still excess capacity in the labour market, employment has increased by about two per cent over the last 12 months and surveys indicate conditions in the household and business service sector have been above average.

The exchange rate has fallen to around its lowest level since 2009 and may depreciate further once the US Federal Reserve begins increasing interest rates. The Governor noted that a lower exchange rate was unlikely to lead to increased inflationary pressures, and the Australian dollar at its current level was helping to support demand for locally produced goods and services, which should in time lead to more investment.

It is encouraging to note the Governor's view that underlying fundamentals of the economy have continued to improve. The adjustment of the decline in the terms of trade is well underway and if non-mining activity continues to improve this will likely lead to better output growth as the Australian economy reaches the later phases of the decline in mining investment.

On behalf of the committee, I would like to thank the Governor of the Reserve Bank, Mr Glenn Stevens and other representatives of the RBA for appearing at the hearing on 18 September 2015. The next public hearing will be held on 12 February 2016 in Sydney.

Craig Laundy MP
Chair

Contents

APPENDICES

TABLE

Membership of the Committee

Chair	Mr Craig Laundy MP (from 13 October 2015)
	Mr John Alexander OAM MP (to 12 October 2015)
Deputy Chair	The Hon Ed Husic MP
Members	Mr John Alexander OAM MP (from 13 October 2015)
	Mr Scott Buchholz MP
	Dr Jim Chalmers MP (to 19 October 2015)
	Mr David Coleman MP
	Mr Pat Conroy MP
	Dr Peter Hendy MP (to 12 October 2015)
	Mr Kevin Hogan MP
	Mr Craig Kelly MP
	Ms Clare O'Neil MP (from 19 October 2015)
	Mr Clive Palmer MP
Supplementary Member	Ms Clare O'Neil MP (to 19 October 2015)

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Ms Marina Katic
Administrative Officer	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.

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 *Sixth Statement on the Conduct of Monetary Policy,* agreed between the then Treasurer, the Hon Joe Hockey, MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix B, 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.

---

1 Reserve Bank of Australia (RBA), *Sixth Statement on the Conduct of Monetary Policy*, 24 October 2013.

Accordingly, the committee may inquire into aspects of the annual reports of the RBA.

Scope and conduct of the review

1.4 The fifth public hearing of the committee with the RBA during the 44th Parliament was held in Canberra on 18 September 2015.

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 Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Dr Oliver'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 hearing was well attended by members of the public and staff and students from Canberra Girls Grammar and Gungahlin College.

1.9 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.

1.10 This report focuses on matters raised at the public hearing, and also draws on issues raised in the RBA's August 2015 *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA's website.[3]

---

2 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBA_2014_Annual_Report/Public_Hearings> viewed 30 September 2015.

3 Reserve Bank of Australia, 'Statement on Monetary Policy', <http://www.rba.gov.au/publications/smp/index.html> viewed 30 September 2015.

Next public hearing with the Reserve Bank of Australia

1.11 The committee will conduct the next public hearing with the RBA on 12 February 2016 in Sydney. More details will be circulated in the weeks leading up to the hearing.

2

Monetary policy and other issues

Overview

2.1 On 1 September 2015 the Reserve Bank of Australia (RBA) decided to leave official interest rates unchanged at 2.0 per cent. At the committee's last hearing with the RBA in February the interest rate was at 2.25 per cent and in May 2015 the RBA lowered the rate to its current 2.0 per cent. In his September statement on the decision, the Governor noted that the current circumstances called for accommodative monetary policy, commenting that:

> The Board today judged that leaving the cash rate unchanged was appropriate at this meeting. Further information on economic and financial conditions to be received over the period ahead will inform the Board's ongoing assessment of the outlook and hence whether the current stance of policy will most effectively foster sustainable growth and inflation consistent with the target.[1]

2.2 The Governor remarked at the public hearing on 18 September 2015 that investment in the resources sector has been falling for about two and a half years now, and will likely fall to about five per cent of Gross Domestic Product (GDP) from its peak of about eight per cent.[2]

2.3 In comparison, there have been indications that the non-mining sectors have experienced a gradual improvement in conditions. The Governor further added that 'survey based measures of business conditions have

---

1 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision,* see: <http://www.rba.gov.au/media-releases/2015/mr-15-15.html>.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 1.

been a bit above their long run average for a while now, and the most recent readings are about where they were in 2010.'[3]

2.4 Employment has increased by about two per cent over the last 12 months, with NSW and Victoria demonstrating the largest increases in demand while conditions elsewhere are more subdued.[4] The Governor added:

> By industry, the rise in employment has been strongest in services, especially those types of services delivered to households, though business service activities have also added to employment over the past year.[5]

2.5 The Governor noted in his opening statement that real GDP growth grew by two per cent over the year to June, consistent with the RBA's forecasts of three months ago.[6]

2.6 The Governor noted that performance in the United States of America (US) continues to improve, and this will eventually lead to less accommodative monetary policy, with the US Federal Reserve (the Fed) expected to raise interest rates this year. In relation to the highly anticipated rate rises he further commented:

> The more important factor, though, I think, is not so much the timing of the first one as the pace of the subsequent increases.[7]

2.7 The Governor added that the movement of subsequent US interest rates will depend on the US economy and as such will be associated with a degree of inevitable uncertainty and the possibility of further financial volatility at a later stage. The Governor remarked, however, that it was likely that 'global interest rates will be quite low for quite some time yet.'[8]

2.8 The Governor reported that growth in the Chinese economy has continued to moderate, and forecasts for global growth over the period ahead as a result are slightly lower than estimates from six months ago.[9]

2.9 The Governor commented that the unwinding of an equity market bubble in China appears to have served as the proximate trigger for a revision of equity valuations around the world.[10] He remarked that risk appetite decreased slightly during this period, and the currencies of many emerging market economies came under downward pressure:

---

3 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 1.

4 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, pp. 1-2.

5 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

6 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 3.

9 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

> To be sure, emerging market countries are under some pressure, and some of those have specific problems that markets recognise and are responding to. At the same time, though, I think it can be said that many emerging market countries have done quite a bit to improve their resilience over the years.[11]

2.10 At the public hearing the Governor updated the committee on the Bank's recent activities that form part of its oversight of the payments system and in particular the recent work of the Payments System Board (PSB).

2.11 The Governor reported on the progress of the New Payments Platform (NPP), a major industry initiative to introduce new payments infrastructure which will enable real-time data-rich payments on a 24/7 basis for households, businesses and government agencies.

2.12 The Governor commented that the PSB is progressing work in this area by facilitating the private sector coming together to drive this project, adding that 'the Reserve Bank itself has to build some architecture of its own to make all this work, and we are making good progress in that.'[12]

2.13 Furthermore, the Governor updated the committee on the Bank's progress into the Review of Card Payments Regulation. The Governor noted that the Bank held a roundtable in June with representatives from over 30 interested organisations. The Governor noted that the Bank would undertake a thorough consultation process on any draft standards if changes to the regulatory framework were proposed.[13]

2.14 During the hearing, the committee questioned the Governor and the other RBA officials on a number of areas, including the cash and exchange rates, business and the labour market, the global economy, housing and the Payments System.

Forecasts

2.15 In its August 2015 *Statement on Monetary Policy*, the RBA stated growth of Australia's major trading partners (MTPs) continues to remain around its long-run average:

> Growth of global industrial production has moderated over the past year or so, which has contributed to lower commodity prices, although the strength of commodity supply has also been a significant factor. In most of Australia's trading partners, core

11 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

12 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 3.

13 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 3.

> inflation has been stable in year-ended terms over recent months at rates below central bank targets. Globally, monetary conditions remain very accommodative and finance remains readily available to creditworthy borrowers.[14]

2.16 Further to this, in its August 2015 Statement the RBA forecast Australian GDP growth to be 'between 2 and 3 per cent over the year to June 2016 and to pick up to above 3 per cent over the year to June 2017.'[15] The RBA added:

> Below-average growth in the near term reflects the large falls in mining investment, which are offset by continued growth in resource exports. Consumption growth is expected to rise and dwelling investment is forecast to remain strong. This increase in household demand, as well as the response of net exports to the exchange rate depreciation, is expected to support a pick-up in non-mining business investment from 2016/17.[16]

2.17 The RBA Statement further indicated that the unemployment rate is now forecast to remain little changed over the next 18 months or so from recent levels, before declining over 2017:

> The unemployment rate is anticipated to be lower than previously forecast. In part, this reflects the generally better-than-expected labour market conditions of late. Moreover, the unemployment rate is expected to remain little changed from recent levels for some time. This is despite the change to the forecast for aggregate demand, which is likely to be broadly matched by lower growth of the economy's productive capacity, owing to lower population growth.[17]

2.18 The Governor noted in his opening statement that inflation remains low, and low interest rates combined with financial institutions that are willing to lend have contributed to improvements in the conditions of some sectors.[18]

2.19 The Statement reported that the inflation forecast had been revised upwards slightly since the previous Statement, mainly due to the further depreciation of the Australian dollar. The Statement further noted:

14 RBA, *Statement on Monetary Policy,* August 2015, p. 1.

15 RBA, *Statement on Monetary Policy,* August 2015, p. 66.

16 RBA, *Statement on Monetary Policy,* August 2015, p. 66.

17 RBA, *Statement on Monetary Policy,* August 2015, p. 66.

18 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

> … underlying inflation is expected to be around 2½ per cent over the forecast period. Inflation expectations remain around or a little below average.[19]

2.20 The RBA notes in its Statement that Consumer Price Index (CPI) inflation increased to 0.8 per cent (in seasonally adjusted terms) in the June quarter, mostly as a result of higher prices for automotive fuel. The RBA further commented:

> Nevertheless, CPI inflation over the year has been low at 1.5 per cent. Fuel prices remain about 10 per cent lower than a year ago, while the removal of the carbon price in the September quarter 2014 has lowered utility prices over the year.[20]

2.21 The August 2015 Statement notes that underlying inflation has been little changed for the past few quarters, with indicators around ½ per cent in the June quarter and indicators suggesting it was about 2¼ per cent over the year.[21] The RBA added:

> Interpreting the year-ended pace of underlying inflation continues to be affected by the indirect effects of the repeal of the carbon price last year on a wide range of prices.[22]

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

	Year-ended					
	June 2015	Dec 2015	June 2016	Dec 2016	June 2017	Dec 2017
GDP growth	2	2½	2-3	2½–3½	3-4	3-4½
CPI inflation[(b)]	1.5	2½	2-3	2-3	2-3	2-3
Underlying inflation[(b)]	2¼	2½	2-3	2-3	2-3	2-3
	Year-average					
	2014/15	2015	2015/16	2016	2016/17	2017
GDP growth	2¼	2¼	2-3	2-3	2½–3½	2½-4

(a) Technical assumptions include A$ at US$0.74, TWI at 62 and Brent crude oil price at US$53 per barrel.

(b) Based on current legislation

Source *Reserve Bank of Australia, Statement on Monetary Policy, August 2015, p. 67*

2.22 At the hearing, the RBA officials discussed trends in recent and future GDP growth (see Table 1), commenting that GDP growth has been

19 RBA, *Statement on Monetary Policy,* August 2015, p. 68.

20 RBA, *Statement on Monetary Policy,* August 2015, p. 59.

21 RBA, *Statement on Monetary Policy,* August 2015, p. 59.

22 RBA, *Statement on Monetary Policy,* August 2015, p. 59.

somewhat marginally below average, and there has been slightly less growth than what was previously forecast. Assistant Governor Dr Christopher Kent commented on the reasons for the weaker than expected growth:

> It is not so much because mining investment is weaker than we thought. In fact, those forecasts have been reasonably accurate. Household consumption growth has improved, just not as much as we had thought and hoped. We keep pushing back on the timing of this hoped-for pick-up in non-mining business investment.[23]

2.23 The Governor commented that while GDP growth has been lower than expected and as a result revised slightly downwards, unemployment has stopped increasing and conditions have improved recently:

> It is a fact that, as measured in leading business surveys, conditions have improved over the past year or two and, as most recently measured, have been above average. That is true. It is a fact there have been more than 200,000 extra jobs created over the past year. Everybody knows our forecast had had the unemployment rate going up a little further. It is a bit variable month to month, so it is a little hard to tell, but it looks like, for the time being, that it has stopped going up.[24]

The cash rate and monetary policy

2.24 At its meeting on 1 September 2015 the RBA decided to keep interest rates unchanged at 2.0 per cent. The RBA noted in its August 2015 Statement on Monetary Policy that low interest rates have supported an increase in consumption since 2013 and are also providing support to housing market conditions, which remain strong overall.[25]

2.25 The Governor explained that leaving interest rates unchanged was appropriate in the current climate and that monetary policy needs to remain accommodative in order to support borrowing and spending.[26]

2.26 The Governor further added that the RBA intends to closely monitor the economic and financial conditions over the period ahead to determine

---

23 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 18 September 2015, p. 14.

24 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 10.

25 RBA, *Statement on Monetary Policy,* August 2015, p. 2.

26 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision,* see: <http://www.rba.gov.au/media-releases/2015/mr-15-15.html>.

whether the current stance of accommodative monetary policy remains appropriate in fostering sustainable growth targets in the future.[27]

2.27 At the public hearing the committee noted the Fed's recent decision to leave interest rates on hold and asked the Governor to provide a comparison of the recent decisions of the Fed and RBA.

2.28 The Governor explained that Australia did not experience a downturn like the US, and while interest rates are low by Australian standards, they have not reached zero.[28] He further commented on the rationale behind Australia's current monetary policy settings in comparison to the US, adding:

> For us, for some time, the question has really been: is this interest rate appropriate to promote growth without running undue risks in the financial space? We think we have got that balance right. But the question has more been, for us: do we hold or should we go down a little bit more? I think we are pretty content where we are right now, but we are not in the same phase of the cycle that the Fed is in.[29]

2.29 The Governor acknowledged the risk that very low interest rates may foster a worrying debt build-up, and noted that the regulatory initiatives in place to maintain sound lending standards and capital adequacy were achieving their purpose.[30] He also noted that the objective of these regulatory tools is 'not to control dwelling prices but to contain leverage.'[31]

The exchange rate

2.30 In its August 2015 Statement on Monetary Policy the RBA outlined general trends in the exchange rate since the previous Statement. It commented that the Australian dollar has depreciated by around eight per cent against the US dollar and by about five per cent on a trade-weighted basis, to be around its lowest level since 2009.[32]

27 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision,* see: <http://www.rba.gov.au/media-releases/2015/mr-15-15.html>.

28 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 4.

29 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 4.

30 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

31 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

32 RBA, *Statement on Monetary Policy,* August 2015, p. 25.

2.31 The RBA's August 2015 Statement also noted in relation to the Fed raising its policy rate 'there is also a reasonable chance that the Australian dollar will depreciate further once that tightening commences.'[33]

2.32 At the hearing, the Governor reported that the significant decline in the exchange rate is starting to have more discernible effects on the pattern of spending and production, adding:

> We are hearing about the effects of this in our liaison and also seeing it in the data on such things as tourism flows, as well as exports of business services. This is to be expected as the exchange rate adjusts to the change in the terms of trade.[34]

2.33 The committee was interested in whether a further fall in the exchange rate would present the potential for inflationary pressures. The Governor responded that he expected the inflation target to be achieved even with the lower exchange rate. He added any inflation is likely to be contained by core domestic inflationary pressures which are currently quite low:

> The rate of growth of wages is very low. Unit labour costs as measured in an aggregate level have not grown for three years—or is it four? Three or four years. So I think that is locking in quite a contained domestic inflation momentum… [35]

2.34 Dr Kent explained that generally the factors that cause a fall in the exchange rate play a significant role in whether the fall is likely to be more inflationary:

> If that fall in the exchange rate has just sort of happened by itself, it is likely to be more inflationary than a fall in the exchange rate that reflects, say, a weakening in global trading conditions or a weakening in commodity prices, which would tend to weaken domestic demand. As the governor suggested, that sort of thing would put downward pressure on wage growth and other domestic costs. So, while you would be having inflation pressures from the traded side of the economy, the non-traded, domestic cost pressures—the wage growth, profit margins and the like—would be subdued if the exchange rate were falling… [36]

---

33 RBA, *Statement on Monetary Policy,* August 2015, p. 3.

34 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 2.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 5.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 5.

Business and the labour market

2.35 In the August 2015 Statement on Monetary Policy the RBA reported that over the next 18 months the unemployment rate is forecast to remain little changed at a level that is slightly lower than earlier forecasts, before declining over 2017 as demand growth picks up.[37]

2.36 The committee asked the Governor whether low wages growth, relatively weak consumer and business confidence and the potential impact of these factors on living standards are significant barriers to lifting consumer sentiment and consequently business investment.

2.37 The Governor responded that surveys have indicated that consumer and business confidence are close to the average, adding that 'it is not the ebullient consumer and business community that we had from the late nineties through to 2006, but I am sorry: that is not coming back.'[38]

2.38 The Governor reported wage growth continues to be low at about two per cent on the Wage Price Index (WPI) and real GDP per head has been quite weak in response to the terms of trade falling.[39] He added that in such circumstances consideration should be given to increasing productivity because 'that is the only source of growth in living standards.'[40]

2.39 In addition to this, the Governor reported on factors that may potentially assist in reducing the unemployment rate in future:

> In the period ahead, if we can get the non-resource part of the economy to keep improving gradually, build some confidence there, see the jobs growth continue and in due course see businesses more inclined to invest and so on there, then we will start to get the unemployment rate to come down, and that is what we should want.[41]

2.40 The committee asked the Governor to provide an explanation between the headline unemployment figure, which appeared slightly more positive in comparison to sub indicators such as the underemployment rate, underutilisation rate and the long-term unemployment ratio that suggest significant excess capacity in the labour market. The Governor responded:

> … if the headline rate of unemployment stops rising and if we could get it to start falling then so will those other things. From a macro-economic point of view, which is where we sit, the best

37 RBA, *Statement on Monetary Policy,* August 2015, p. 3.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 7.

39 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 7.

40 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 7.

41 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 14.

> thing we can do is to try to generate growth in the economy above whatever its potential is, for a while, and start the headline unemployment rate coming down, and that will certainly help to bring those broader measures of underutilisation down.[42]

2.41 The committee asked the Governor his view on whether the excess capacity in the labour market could be contributing to weaker consumer confidence.

2.42 Dr Kent remarked that whilst surveys have indicated that confidence amongst businesses are not particularly high or low, the current experience of conditions in the household and business service sector has been above average.[43] The Governor added:

> It could be, but at the same time I think Chris earlier gave some facts about the responses in surveys to people's perception of their own financial wellbeing having improved. Though what you say is doubtless true for those people, at a broader level what the survey seems to be saying is: 'You asked me about the economy? I'm a bit worried. Ask me about how I'm doing? Actually, I'm doing better than I was.' There is a bit of a disconnect there …[44]

2.43 The committee asked the Governor about the underlying reasons that non-mining capital investment has not provided the boost to the economy in accordance with expectations over the last two years. The Governor noted there were a number of potential reasons for this, commenting:

> We had a very large financial crisis globally. We escaped the worst of that, but that has infected psychology, I think, internationally, and you can't help but have some of that spill over. Domestically, we have got these very large swings in relative prices in the economy, to do with the terms of trade. Adjustment is always challenging. On top of that, you had the long gearing-up of the household sector, which came to an end in about 2006 and will not return, and strategies have been adjusting to that change…[45]

2.44 Further to this, Deputy Governor Dr Philip Lowe added that while underlying fundamentals have gradually been improving, there is an ongoing desire to wait and see how the uncertainties resolve.[46] He noted

42 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 16.

43 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 18 September 2015, p. 8.

44 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 16.

45 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 15.

46 Dr Philip Lowe, Deputy Governor of the RBA, *Transcript,* 18 September 2015, p. 15.

that 'if we just get a little decline in uncertainty, I think we are quite close to the point where we will see business investment start picking up.'[47]

United States

2.45 At the public hearing the Governor commented that the Fed was likely to start increasing interest rates by the end of the year, for the first time in nine years. The committee was interested in the likely rate of subsequent rate rises and the potential impact on the domestic economy. The Governor responded:

> I think one could be concerned about the possible spillover effects that might come from that. That is normally a potential concern when the US changes monetary policy because, as I say, dollar funding rates really reverberate right around the world, especially into the emerging world. What tends to happen is that many developing countries find that their credit conditions start to tighten a bit when the Fed starts to lift.[48]

2.46 Furthermore, the Governor noted that the length of time the rate has been at zero adds some additional uncertainty. However, the increase has been anticipated for some time and many countries in the emerging world have been working on strengthening policy frameworks so that they are in a better position to cope than may have been the case previously.[49]

2.47 The committee asked the Governor about the likely long-term average borrowing rate in the US. The Governor stated 'we are not going to have zero for the policy rate in the US but not four or five per cent in the way we once did, at least not for quite some time.'[50]

2.48 The Governor added that the long-term rates in markets suggest that the average for the US over the next five years was likely to be lower than those prior to the financial crisis.[51]

2.49 The committee was interested in the impact the Fed's recent decision to hold rates could have on the Australian economy. The Governor commented:

> I would still say that the fact that they are talking about and debating when to do it is a positive sign in the sense that they have

47 Dr Philip Lowe, Deputy Governor of the RBA, *Transcript,* 18 September 2015, p. 15.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 4.

49 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 4.

50 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 14.

51 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 14.

> come to the view that they are close to the time when they do not need interest rates at zero in the context of a massively larger federal reserve balance sheet. If they get to the point where they can see their way clear to just lift off, as they put it, from zero and go to something that is still very low—still remarkably accommodating, but just not so remarkably expansionary—I think that is a good sign.[52]

2.50 The committee noted some concerns around the possibility that the interest rates in the US could be kept too low for too long, and asked the Governor what the potential consequences of that might be. The Governor stated that 'it is possible and, if it happened, it would not be the first time.'[53]

2.51 The Governor added that in the current environment, the biggest risk is that these accommodative circumstances lead to too much financial-risk taking in the search for yield, resulting in negative consequences when the rates eventually go up.[54] He commented on the potential for such outcomes in the context of the current global financial climate:

> That risk clearly exists, given that we have not only the Fed but the Bank of Japan having zero rates more or less for 13 years. The ECB has a zero, even negative, rate, and it will do so for some time.[55]

China

2.52 In his opening statement the Governor made comments on the easing of growth in the Chinese economy and the likely repercussions of this for the global economy. The committee was interested in whether the RBA could implement any pre-emptive measures to mitigate the effects on the domestic economy a possible sharp downturn in the Chinese economy may have.

2.53 The Governor responded that the Chinese economy has not experienced such a downturn to date. The Governor stated 'we can lower interest rates if there is a case to do that.'[56] Also adding that if such events were to occur 'you would expect in that world that the exchange rate is going to go

52 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 7.

53 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 19.

54 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 19.

55 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 19.

56 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 4.

down, probably quite a bit, and that will be one of the key mechanisms that help the Australian economy cope.'[57]

2.54 The Governor noted that the Chinese economy is going through a period of transition where services, domestic spending and consumption are increasing as drivers of the economy, while physical investment spending and exports are decreasing. He added that this transition was still a work in progress.[58]

2.55 The committee asked the Governor to provide forecasts on the slowdown of the Chinese economy into the future. The Governor noted the economy was continuing to slow and 'it is impossible to know whether they might have a sharper cyclical slowdown'.[59] He stated:

> Longer term, China cannot keep growing at even seven per cent—assuming that seven is an accurate figure. No economy that is that large grows that fast indefinitely. Into the years ahead, as we go forward through the next 10 years, we should be expecting to see sixes and fives in growth rates, not sevens or eights or nines. I think that is now pretty widely understood.[60]

2.56 The committee asked the Governor whether the lowering of tariffs of Australian goods going into China as part of the free trade agreement is likely to encourage the much anticipated growth in the non-mining sector that the Australian economy is currently lacking. The Governor commented:

> … we would be generally supportive of freer trade. I think there is the issue of whether 50 free trade agreements with 50 countries amounts to the same thing as multilateral free trade, and that is quite a complicated question, but in the present world it does not seem that getting a multilateral free trade agreement globally is on the table.[61]

Housing

2.57 The committee was interested in the recent action taken by regulators to restrict the increase in borrowings on investment properties by 10 per cent. The committee asked the Governor whether the RBA and other

57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 18 September 2015, p. 4.

58 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 18 September 2015, p. 15.

59 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 18 September 2015, pp. 14-15.

60 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 18 September 2015, p. 15.

61 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 18 September 2015, p. 18.

regulators are satisfied that this restriction is adequate and whether the implementation of other mechanisms should be considered.

2.58 The Governor responded that the effect of the recent actions has overall been positive in stabilising the flow of new lending to investors, however he noted that 'there have been some material concerns about the quality of data in the credit data.'[62] The Governor stated:

> … the key things that APRA has been talking about are lending standards. I think it is very important for them to have an intensive check on the standards that are being applied and, in some cases, it is turning out that those standards were not quite as high as the banks might have said. So it is good to fix that.[63]

2.59 Furthermore, the Governor noted that the main objective behind imposing the restrictions was to contain leverage and ensure prudent and adequately capitalised lending.[64] He provided commentary on how the recent restrictions on investor lending is likely to impact lending dynamics in the future:

> The reason we were focused on investors is that that is where the faster credit growth was. I predict we will now see a number of people who used to call themselves investors are going to call themselves owner-occupiers because the relative pricing has changed. That will lead to some interesting dynamics, I suspect, over the next year.[65]

2.60 The committee asked the Governor his view on whether these adjustments had occurred in a timely manner. The Governor commented that he considered the degree of forcefulness and approximate timing of the adjustments to be appropriate.[66]

2.61 The committee was interested in a statement the RBA made in its submission to the home ownership inquiry, where the RBA said:

> The Bank believes that there is a case for reviewing negative gearing, but not in isolation. Its interaction with other aspects of the tax system should be taken into account.[67]

2.62 The committee asked the RBA to expand on the statement and provide reasons why negative gearing should be reviewed. The Governor

62 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 5.

63 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 5.

64 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 6.

65 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 6.

66 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 6.

67 House of Representatives Standing Committee on Economics, Inquiry into home ownership, RBA, *Submission 21,* p. 23.

responded that it would be appropriate to consider negative gearing collectively with other aspects of the tax system:

> … the thing I would stress is there are other aspects of the tax system too that also matter here: capital gains tax, depreciation et cetera. All of these things interact, and I cannot help feeling it would be a mistake to just say we should or should not tweak negative gearing per se without thinking about the interaction of the various other bits.[68]

2.63 Assistant Governor Dr Malcolm Edey added that it is misleading to consider negative gearing in isolation of the other components of the tax system, particularly the capital gains tax.[69]

The Payments System

2.64 The committee asked the Governor to provide an update on progressing the objectives of the 2012 Strategic Review of Innovation, in particular the ability to make real-time retail payments, low-value payments outside normal banking hours and more complete remittance information. The Governor noted that the project overall had made fair progress given its large scale.[70]

2.65 He reported that a corporate entity, NPP Australia, has been established to construct the architecture for the project, which is being built in two parts. He added that the RBA itself will be required to build some of its own IT capabilities, stating 'that is probably a $25 million project for the RBA over a number of years.'[71] In relation to meeting the original deadline for completion the Governor added:

> The work is underway. The technology, the architecture solution, has been chosen. The builds are underway. It may not quite meet the original deadline we had, but I am confident that it will not be too much later than that. I think, given the magnitude of the undertaking, our view is that we are pleased with the progress.[72]

2.66 In relation to the RBA's Review of Card Payments Regulation, the committee asked the Governor about proposals to level the playing field for interchange fees (and other fees) between the American

68 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 9.

69 Dr Malcolm Edey, Assistant Governor of the RBA, *Transcript,* 18 September 2015, p. 9.

70 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 11.

71 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 11.

72 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 11.

Express/Diners-style cards and the MasterCard/Visa-style cards. The Governor responded:

> … the Financial System Inquiry—if I recall—supported having interchange regulation; it had a few suggestions about possibly extending it and bringing the caps down. We are in the process of deliberating on all this at the moment, so I do not foreshadow any particular outcome. But I do not think that the answer to the claim that the playing field is not level between the three party schemes and the four party schemes, if that is a problem, is to remove the regulation on the four party guys, as much as they would like that and continue to lobby for it.[73]

2.67 The committee was interested in the current regulatory arrangements of the PSB and in particular the conduct of consultations during the decision making process. The committee asked RBA officials whether there is greater scope for the PSB to be more transparent, improve consultations with the sector and potentially move the PSB to another regulator to enable oversight of the types of consumer protection issues that do not fall within the RBA's mandate.

2.68 Dr Edey responded that all of those issues were examined within the scope of the Financial System Inquiry (FSI), and the 'FSI itself concluded that the current arrangements have worked well.'[74]

2.69 The committee expressed concern that the mechanisms that ensure transparency in the operations of the PSB were not being applied adequately.

2.70 In relation to the scope to improve transparency, the Governor stated 'I think the process is quite transparent.'[75] He noted that decisions on monetary policy are quite different in nature to the decisions made by the PSB, therefore drawing parallels between the two processes was difficult:

> The Payments System Board makes different sorts of decisions. The issues on which it decides typically have quite a long gestation, and on any given particular topic that we might be working on…there is not a monthly decision on all of those things. There is a periodic point at which we decide, 'Okay, we're going to do X,' and then there will be a statement to that effect, not on the day but in short order, and it is not as though every financial price

73 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 12.

74 Dr Malcolm Edey, Assistant Governor of the RBA, *Transcript,* 18 September 2015, p. 21.

75 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 21.

> in the country is waiting on that decision that day, the way it is on the interest rate decision.[76]

2.71 The committee asked RBA officials to outline the conduct of the consultation process for the RBA's Review of Card Payments Regulation, in particular whether the RBA announced that there was going to be a review and had detected any criticism from the sector that this process had not occurred over an adequate time frame. Dr Edey summarised the consultation process the RBA had undertaken:

> … the review that we announced in March was a response to an FSI that had been going for more than a year at that time. So we made the formal announcement in March with an issues paper, and we gave industry about six weeks to respond. We received a lot of submissions. We then followed that up with bilateral discussions with all the key players who made submissions, and then a roundtable with the industry collectively, and with consumer and merchant interests in June.[77]

2.72 Dr Edey further commented that the PSB must undertake an extensive consultation process, by law, whenever contemplating regulatory action, that serves as a primary mechanism through which transparency is achieved in the PSB's decision making process:

> … usually, if there is something to announce, it will be announced within a week or two after a meeting.
>
> But the way the PSB works is that there is not necessarily something that is up for a decision at a meeting. If there is something that is up for a decision, and a decision gets made, and we have to take an action, then we will announce that. A big part of the transparency process is not the media releases; it is the consultation processes that, by law, we have to go through whenever we are contemplating regulatory action. Those are very extensive. We publish issues papers whenever we are contemplating that. We then go through the consultation processes. We then have to consult again whenever we want to produce draft standards.[78]

2.73 The committee drew attention to statements the RBA made during a recent Senate Economics References Committee inquiry that suggested media releases were released after each PSB meeting to summarise the issues discussed and actions taken at the meeting. The committee

76 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 18 September 2015, p. 21.

77 Dr Malcolm Edey, Assistant Governor of the RBA, *Transcript,* 18 September 2015, pp. 19-20.

78 Dr Malcolm Edey, Assistant Governor of the RBA, *Transcript,* 18 September 2015, p. 20.

expressed concern that this practice was not occurring on a regular basis despite the evidence given to the recent Senate inquiry.

Conclusion

2.74 Australia's economic outlook over the coming years appears positive overall, despite the expected gradual fall in mining investment that has continued. Non-mining sectors have seen gradual improvements in conditions and employment has increased two per cent over the last 12 months. Unemployment forecasts reflect generally better than expected labour market conditions and unemployment is forecast to remain unchanged for about 18 months before declining in 2017.

2.75 While recent GDP growth was lower than expected, forecasts for future growth are positive indicating continued growth through 2016 and an increase to above three per cent by June 2017. Factors that are expected to support this pick up in GDP are an increased growth in consumption and household demand, continued strong investment in real estate, increased net exports due to the exchange rate depreciation and continued jobs growth and business investment in the non-resource sector.

Craig Laundy MP
Chair
12 November 2015

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Friday, 18 September 2015 – Canberra

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Dr Philip Lowe, Deputy Governor
Dr Christopher Kent, Assistant Governor (Economic)
Dr Malcolm Edey, Assistant Governor (Financial System)

Private briefing

Wednesday, 16 September 2015 – Canberra

Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital

B

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

The Treasurer and the Governor of the Reserve Bank

24 October 2013

The Statement on the Conduct of Monetary Policy (the Statement) has recorded the common understanding of the Governor, as Chairman 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 inflation.

Low inflation assists business and households in making sound investment decisions. Moreover, low inflation underpins the creation of jobs, protects the savings of Australians and preserves the value of the currency.

In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving 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.

Financial Stability

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.