

Monetary policy and other issues

Overview

- 2.1 On 6 February 2018, the Reserve Bank of Australia (RBA) decided to leave official interest rates unchanged at 1.50 per cent. The cash rate has remained unchanged since the committee's last hearing with the RBA in August 2017. The most recent movement in official interest rates was the RBA's reduction of the cash rate by 25 basis points on 4 August 2016.¹
- 2.2 In his opening statement to the committee, the Governor remarked that while the 'next move in interest rates here will be up rather than down', the RBA board 'does not see a strong case for a near-term adjustment of monetary policy'. The Governor explained:
- The timing of any future move will depend upon the extent and pace of the progress that we make in reducing the unemployment rate and having inflation returned to target. As things currently stand, we expect that progress to be steady but to be only gradual.²
- 2.3 In its February 2018 *Statement on Monetary Policy*, the RBA noted that conditions in the global economy have continued to improve in recent months. It reported that growth has 'been most pronounced in manufacturing and industrial activity, and has been more synchronised across economies than has been the case for some time.'³
- 2.4 The Governor remarked in his opening statement to the committee that stronger growth had reduced rates of unemployment around the world:

1 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, *Media Release No. 2018-01*, 6 February 2018.

2 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 3.

3 RBA, *Statement on Monetary Policy*, February 2018, p. 1.

In a number of countries the unemployment rate is now below conventional estimates of full employment. Inflation has also remained low, partly reflecting the fact that wage growth is subdued. Low inflation has also meant that interest rates are low and for much of the past year volatility in asset prices was also unusually low.⁴

2.5 The RBA expects domestic economic conditions to improve as the global economy strengthens, with GDP growth forecast to rise from 2¾ per cent in mid-2018 to be a little over 3 per cent over both 2018 and 2019.⁵

2.6 The RBA reports that the unemployment rate has declined by a quarter of a percentage point over 2017, to 5.5 per cent.⁶ The Governor remarked:

We don't expect a repeat of these very strong outcomes again in 2018, but we do expect employment growth to be fast enough to see a further gradual reduction in the unemployment rate.⁷

2.7 Inflation and wage growth remain low and are expected to pick up gradually as the economy strengthens. The Governor commented in his opening statement:

The pick-up, though, is likely to be gradual. The increase in wages growth and the more general reduction in spare capacity in the economy are expected to contribute to inflation picking up as well. But, to continue the theme, this pick-up too is expected to be only gradual. This year and next, we expect CPI inflation to be between two and 2½ per cent.⁸

2.8 The RBA reports that non-mining business investment has increased by almost 10 per cent over the year to the September quarter 2017, and the outlook remains positive.⁹

2.9 During the hearing, the committee questioned the Governor on the RBA's monetary policy settings given the low levels of inflation in the Australian economy, and the prospects for a pick-up in inflation and wage growth as the economy strengthens. The effectiveness of macroprudential measures to contain risks in the housing market, and the rollout of the New Payments Platform (NPP) were also discussed.

4 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 1.

5 RBA, *Statement on Monetary Policy*, February 2018, p. 2.

6 RBA, *Statement on Monetary Policy*, February 2018, p. 33.

7 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

8 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 3.

9 RBA, *Statement on Monetary Policy*, February 2018, p. 29.

Forecasts

2.10 In its February Statement, the RBA forecasts Australia's GDP growth to increase to just over three per cent during 2018 and 2019. Inflation remains low, with underlying inflation expected to increase gradually to be around 2¼ per cent by 2020 (see Table 1).¹⁰

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

	Year-ended					
	Dec 2017	June 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020
GDP growth	2½	2¾	3¼	3½	3¾	3
Unemployment rate	5.5	5¼	5½	5¾	5¾	5½
CPI inflation	1.9	2	2¼	2½	2¾	2¾
Underlying inflation	1¾	1¾	1¾	2	2	2¼
	Year-average					
	2017	2017/18	2018	2018/19	2019	2019/20
GDP growth	2¼	2¾	3	3¼	3¾	3¾

Source Reserve Bank of Australia, *Statement on Monetary Policy, February 2018*, Table 6.1, p. 63.
(a) Technical assumptions include A\$ at US\$0.78, TWI at 64 and Brent crude oil price at US\$64 per barrel.

2.11 The RBA expects the growth of Australia's major trading partners to be a little stronger, 'reflecting stronger-than-expected data for some economies and the expected boost to demand from US tax cuts'.¹¹

2.12 The Governor was questioned on the strength of Australia's forecasted GDP growth. He attributed the increasing rate of growth to the pick-up in investment and business confidence, and said he expected consumption growth to 'gradually pick up as well'.¹²

2.13 The Governor also noted that increases in Liquefied Natural Gas (LNG) exports are expected to add about a quarter of a per cent to GDP growth over the next few years.¹³

2.14 The RBA noted in its February Statement that, domestically, a key uncertainty in relation to its forecasts is the outlook for the labour market:

This comes from two sources. First, it is not clear how much spare capacity there is in the labour market and how quickly it might

¹⁰ RBA, *Statement on Monetary Policy*, February 2018, pp. 2-3, 63.

¹¹ RBA, *Statement on Monetary Policy*, February 2018, pp. 2-3, 63.

¹² Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

¹³ Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 5.

decline, particularly given the recent strength in the participation rate. Second, it is unclear how much any decline in spare capacity will translate into building wage pressures.¹⁴

- 2.15 The Governor was asked if he was encouraged by recent data that suggested government revenue is ahead of the projections contained in the Mid-Year Economic and Fiscal Outlook 2017-18 (MYEFO). The Governor said that, while those forecasts were not his responsibility, he was encouraged by 'the factors that are driving any improvement in the underlying budget: the pick-up in commodity prices..., the strong jobs growth and the restraint in spending.'¹⁵
- 2.16 The Governor said that this was a positive development because of 'the need to have sustainable fiscal policy' and remarked 'if we're moving in that direction a bit quicker than was originally projected, I think that's good.'¹⁶

The cash rate and monetary policy

- 2.17 At its meeting on 6 February 2018, the RBA left official interest rates on hold at 1.50 per cent. In his statement on the decision, the Governor remarked:

The low level of interest rates is continuing to support the Australian economy. Further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual. Taking account of the available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time.¹⁷

- 2.18 In his opening statement, the Governor said the RBA considered the cash rate an 'accommodative setting of monetary policy aimed at supporting the economy and employment and returning inflation to the midpoint of the medium-term target range'.¹⁸ He said that the RBA Board has attempted to 'strike a balance between these benefits of monetary stimulus

14 RBA, *Statement on Monetary Policy*, February 2018, pp. 65-6.

15 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 26.

16 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 26.

17 RBA, 'Statement by Philip Lowe, Governor: Monetary Policy Decision', *Media Release 2018-01*, 6 February 2018.

18 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 3.

and the medium-term risks associated with an increase in the already high levels of household debt.¹⁹

- 2.19 The Governor was questioned on the RBA's monetary policy settings given the persistently low levels of inflation in the Australian economy. The Governor responded:

As we've talked about at these hearings before, we could have had lower interest rates over the last couple of years to try and get inflation up more quickly, and our judgement was that it was not in the national interest to do that because the way we would have got inflation up more quickly would have been to encourage people to borrow yet more than they were already borrowing and push up asset prices even further. So our judgement, rightly or wrongly, was that it was not in the national interest to do that.²⁰

- 2.20 The RBA's February Statement reported that some central banks have continued to unwind monetary stimulus as the global economy has strengthened and spare capacity in labour markets has lessened. The United States Federal Reserve increased its policy rate by 25 basis points in December, its third increase in 2017.²¹ Similarly, the Bank of Canada raised its cash rate by 25 basis points in January. While the European Central Bank has 'maintained very accommodative policy settings', it is expected to start raising its policy rate in early 2019.²² The Bank of Japan has left its policy rate unchanged since 2016 and is not expected to alter its 'extremely accommodative policy settings' in the near term.²³

- 2.21 The RBA was asked for an update on quantitative easing. Deputy Governor, Dr Guy Debelle, noted that 'the US government is issuing more debt to fund its budget deficit, and the central bank is no longer buying the amount of bonds that it was doing; in fact, it's letting those holdings run down.'²⁴ The Deputy Governor commented:

In the rest of the world, the Bank of Japan is still buying, basically speaking, about as many as it has done for the last number of years, but the European Central Bank has started to run down its bond-buying program, and there's some expectation that, come the end of the year, that may cease. So those dynamics, particularly in

19 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 3.

20 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 11.

21 RBA, *Statement on Monetary Policy*, February 2018, p. 15.

22 RBA, *Statement on Monetary Policy*, February 2018, p. 16.

23 RBA, *Statement on Monetary Policy*, February 2018, p. 16.

24 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 23.

the US and to a lesser extent in Europe, have actually changed somewhat over the past six months.²⁵

- 2.22 In its February Statement the RBA outlined general trends in the exchange rate since the previous Statement. It noted that the Australian dollar has appreciated against the US dollar in recent months, but has remained within a 'relatively narrow range' on a trade-weighted basis for the past two years.²⁶ The RBA noted that, since 2016, the Australian dollar has appreciated against a number of currencies with the 'notable exceptions' being the Yen and the Euro.²⁷
- 2.23 When asked if he was concerned about the strength of the Australian Dollar, the Governor pointed out that 'on a trade-weighted basis, the Australian dollar is basically in the middle of the range that it has been in for the last couple of years. I think that is manageable'.²⁸
- 2.24 The Governor further remarked that the strength of the Australian Dollar against the US dollar is 'largely a US dollar story', which has 'been weak in global markets for quite a few months now'.²⁹

Business and the labour market

- 2.25 The Governor noted that, since the previous hearing in August 2017, a number of business indicators have improved:
- It would be an exaggeration to say that animal spirits have fully returned, but the mood has certainly brightened in much of the business community. There are a number of reasons for this, but in parts of the country the lift in mood is being supported by the large infrastructure investment that is underway. Not only are these projects adding to jobs today but they are building much-needed productive capacity for the future.³⁰
- 2.26 When asked to explain the drivers of business confidence and investor sentiment, the Governor said that the 'global upswing' in growth, increasing investment and international trade is having 'flow-through effects into Australia'.³¹

25 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 23.

26 RBA, *Statement on Monetary Policy*, February 2018, p. 23.

27 RBA, *Statement on Monetary Policy*, February 2018, p. 23.

28 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 23.

29 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 23.

30 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

31 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

- 2.27 The Governor noted that, domestically, the unwinding of the mining investment boom has almost come to an end, which ‘was a drag on the economy’.³² He also pointed to the effects of accommodative monetary policy, and remarked that ‘low interest rates are helping’ and that financial conditions are ‘accommodative, so firms can get access to finance if they need it’.³³ The Governor added that there is currently a ‘very large pipeline of infrastructure investment that’s being undertaken, largely by the private sector, meaning order books of many firms are full’.³⁴
- 2.28 The RBA reported that, by industry, the pick-up in year-ended growth in 2017 was ‘largely attributable to the recovery of growth in goods-related industries, including construction and manufacturing’.³⁵
- 2.29 The Governor was questioned on the strength of the non-mining sectors of the economy following the transition away from the mining boom. The Governor noted that growth in non-mining investment was better than the RBA expected, having increased by nearly ten per cent in the past year.³⁶ The Governor remarked ‘that hasn’t happened for at least half-a-dozen years, probably longer. So it’s a positive story’.³⁷
- 2.30 The Governor noted that ‘both international trade and commodity prices have picked up and both of these things are helping the Australian economy.’³⁸ He was asked whether an increase in commodity prices might not be such an advantage to Australia, given that some of the profit ends up offshore in the form of higher dividends. The Governor said that he did not think that was the case. He noted that ‘some of it gets sent offshore in the form of higher dividends. But the tax revenue is up because of the higher commodity prices.’³⁹

Strong employment growth

- 2.31 The RBA reported in its February Statement that labour market conditions have improved considerably more than expected over 2017, with strong growth in full-time employment and a decline in the unemployment rate

32 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

33 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

34 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

35 RBA, *Statement on Monetary Policy*, February 2018, p. 28.

36 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4; RBA, *Statement on Monetary Policy*, February 2018, p. 29.

37 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 4.

38 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 1.

39 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 20.

to 5.5 per cent.⁴⁰ Notably, the participation rate has risen sharply this year to be at its highest level since the record high in 2011.⁴¹

- 2.32 The Governor was asked whether this strong employment growth would lead to an improvement in household incomes. The Governor responded ‘more jobs mean more income...with 400,000 people getting jobs over the past year, that generates a lot of extra income for the household sector, even if wage growth is kind of moderate’.⁴²
- 2.33 Assistant Governor, Dr Luci Ellis, noted that the high workforce participation rate has been driven by strong growth in female full-time employment. Dr Ellis said ‘what’s really remarkable about the last three to six months in particular has been that there’s been a lift right across the age groups for all women, from mid-20s all the way up’.⁴³
- 2.34 The Governor was asked about recent seasonal trends in employment, and said that ‘one of the things we’ve noticed in the last three Januaries is that there have been very big declines in full-time employment and big increases in part-time employment’.⁴⁴ However, he noted that, in February, that trend ‘kind of gets reversed around’ and that ‘I wouldn’t draw any conclusions from looking too much into the detail of the January data, given the seasonal patterns’.⁴⁵

Dr Ellis added:

There have been a number of months over the past year where the full-time number fell and the part-time number rose, and the total was still strong – and that just turns around next month. It is much better to look at it quarterly and over the full year. Over the full year, full-time employment grew by more than three per cent.⁴⁶

Wage growth

- 2.35 The RBA’s February Statement reported that wage growth in Australia ‘remains subdued’, reflecting similarly slow wage growth in a number of other advanced economies.⁴⁷ The RBA forecasts that wage growth will

40 RBA, *Statement on Monetary Policy*, February 2018, p. 33.

41 RBA, *Statement on Monetary Policy*, February 2017, p. 33.

42 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 5.

43 Dr Luci Ellis, RBA Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 5.

44 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 21.

45 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 21.

46 Dr Luci Ellis, RBA Assistant Governor, *Transcript*, 16 February 2018, p. 21.

47 RBA, *Statement on Monetary Policy*, February 2017, p. 2.

increase gradually and reports that there have been signs of a pick-up in wage growth in some sectors.⁴⁸

- 2.36 The Governor explained that slow wage growth is being shaped by ‘forces of technology and global competition. Workers feel like they just can't put their wages up, and firms aren't aggressively bidding for workers in tight labour markets.’⁴⁹ According to the Governor, competition amongst businesses has been driving cost control and dampening wages:

It partly comes down to the psychology that has existed since the financial crisis, and that psychology is about cost control.

Everyone feels there's so much competition; they're so uncertain about the futures of the firms – a lot of competition, and they feel uncertain about the future – that the last thing they want to do is increase their cost base. Paying workers more increases their cost base. Eventually I think they'll have to because the labour markets become so tight that you have to pay workers more.⁵⁰

- 2.37 When asked if strong employment growth will result in a lift in wages, Dr Ellis said:

It's extremely important, firstly noting that participation does seem to move with employment. We're currently in a position where there is still spare capacity in the labour market. As I said in that speech a couple of days ago, we think that, broadly speaking, an unemployment rate of around five per cent is what you would call our best estimate of a conventional measure of full employment, below which you start seeing a pick-up in wage growth. It's not the minimum employment rate you can have, but it's the rate of unemployment below which you would pick up in wage growth. We're still a bit above that – we're currently at 5½ per cent.⁵¹

- 2.38 Dr Ellis explained that the non-accelerating inflation rate of unemployment (NAIRU) is a level of unemployment below which inflation rises. Dr Ellis commented that the NAIRU ‘is unobservable’, and that ‘you can only estimate where it is based on what happens to wages and inflation’.⁵² In Australia, the NAIRU is currently estimated at about five per cent.⁵³

48 RBA, *Statement on Monetary Policy*, February 2017, p. 2.

49 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 9.

50 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 15.

51 Dr Luci Ellis, RBA Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 5.

52 Dr Luci Ellis, Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 8.

53 Dr Luci Ellis, Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 8.

2.39 The Governor was asked if current methods of estimating the NAIRU misjudge the amount of slack in the labour market, which in turn adversely affects other forecasts including those used to prepare the Budget. The Governor responded:

We've been wrong. Treasury's been wrong. Right round the world, people have been wrong. It's the most frequently discussed issue that I talk about with my colleagues, the governors of the other central banks, and they're all struggling with the same issue. They thought wage growth would pick up as their unemployment rates came down, and it hasn't happened. So we're not alone here.⁵⁴

2.40 When asked if the Treasury's 2017-18 MYEFO forecast for wage growth was ambitious, the Governor replied:

It remains to be seen. The current trends will have to change a bit to get there. We're expecting wage growth to pick up but for it to be fairly gradual.⁵⁵

2.41 The Governor noted that a number of enterprise agreements have been signed recently, which incorporated lower wage increases than the ones they replaced. He further observed that as the enterprise agreements typically remain in place for three years, it would 'act as a weight on wages growth for a while'.⁵⁶

2.42 However, the Governor remained 'sufficiently optimistic' about the prospect of wage rises and stated 'I still believe in the basic laws of supply and demand that eventually, when you have tight labour markets, prices respond'.⁵⁷

2.43 The Governor was asked if recent strong wage growth figures from the United States signposted a shift to stronger wage growth in Australia. The Governor responded:

I wouldn't describe it as a breakout yet, but it did surprise people that wage growth in the US had picked up. For me it was confirmation that the laws of supply and demand still work. Tight labour markets eventually result in firms paying higher wages, and that looks like it's starting to happen in the United States.⁵⁸

54 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 9.

55 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 9.

56 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 6.

57 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 15.

58 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 17.

Household sector

2.44 The Governor remarked in his opening statement that, against a ‘general backdrop of improving conditions, one uncertainty remains the strength of consumer spending’.⁵⁹ The Governor commented:

In the September quarter, spending growth was quite weak, especially for discretionary items. More recently, the retail trade figures have been better and they suggest a stronger outcome for the December quarter. But most households are experiencing only slow growth in their incomes and many expect that this will continue for some time yet. The lowering of expectations about income growth is likely to be affecting spending, especially in an environment of high levels of household debt.⁶⁰

2.45 While the RBA was continuing to monitor household balance sheets, the Governor said ‘there has been some containment in the build-up of risk in this area’.⁶¹ He explained that ‘lending standards are stricter than they were previously and there has been a welcome decline in the share of interest-only loans’, following measures undertaken by the Australian Prudential Regulation Authority (APRA).⁶²

Measures to reinforce sound residential mortgage lending practices

2.46 In December 2014, APRA wrote to all Authorised Deposit-taking Institutions (ADIs) advising of its intent to reinforce prudent residential mortgage lending practices through a number of measures, in particular increasing supervision of ADIs with annual investor credit growth materially above a benchmark of 10 per cent.⁶³

2.47 In March 2017, APRA again wrote to all ADIs advising that it expects ADIs to:

- limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending, and within that:
 - ⇒ place strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 per cent;
 - and

59 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

60 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

61 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

62 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

63 APRA, *Letter from APRA to all ADIs, 9 December 2014*, <<http://www.apra.gov.au/adi/Publications/Documents/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf>>, viewed 22 February 2018.

⇒ ensure there is strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 per cent;

- manage lending to investors in such a manner so as to comfortably remain below the previously advised benchmark of 10 per cent growth;
- review and ensure that serviceability metrics, including interest rate and net income buffers, are set at appropriate levels for current conditions; and
- continue to restrain lending growth in higher risk segments of the portfolio (e.g. high loan-to-income loans, high LVR loans and loans for very long terms).⁶⁴

2.48 The Governor was asked about the effects of these measures on bank lending practices, particularly with respect to investor and interest-only loans. He said that APRA's measures have had a positive impact on risk:

We see the share of interest-only loans in new lending at the moment at around 20 per cent. Investor credit growth has slowed a lot and aggregate household credit growth is now fairly moderate. And lending standards have been improved a lot. So we feel like the risks that were building in the household sector have been contained a bit. There is still risk there, because the level of debt is high, but the risks have been contained.⁶⁵

2.49 The Governor was asked about the major banks decision to raise their rates on existing interest-only loans, despite APRA's March 2017 regulatory measure only targeting the quantity of new interest-only loans.⁶⁶ The Governor said:

Sometimes I see it written that that's because of the regulation. I think that's a misreading. It's a reflection of the state of competition in the banking system; it wasn't a result of the regulatory restrictions.⁶⁷

2.50 When asked if a lack of competition was behind the major banks' decision to reprice their back books, the Governor replied:

64 APRA, *Letter from APRA to all ADIs – Further measures to reinforce sound residential mortgage lending practices*, 31 March 2017, <<http://www.apra.gov.au/adi/Publications/Documents/Further%20measures%20to%20reinforce%20sound%20residential%20mortgage%20lending%20practices.pdf>>, viewed 22 February 2018.

65 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 7.

66 See: House of Representatives Standing Committee on Economics, *Review of the Four Major Banks (Third Report)*, December 2017, pp. 8-14.

67 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 25.

I don't know whether it's a lack of competition. It's a reflection on the nature of competition and the structure of the standard mortgage contract in the Australian market.⁶⁸

- 2.51 The Governor was questioned whether APRA's restrictions on interest only loans has locked in market share for the major banks to the detriment of smaller lenders. The Governor said that while he did not think that it has affected competition for interest-only loans, 'it's more of an issue on the 10 per cent growth on investor lending.'⁶⁹

Household debt

- 2.52 When asked about the distribution of household debt, Assistant Governor Michele Bullock said that 'it is disproportionately held by the higher income and higher wealth families'.⁷⁰

- 2.53 The Governor was asked about recent analysis by UBS Global Research which suggested that many borrowers are materially overstating their household income to secure a mortgage. When asked if he was concerned by this, the Governor said 'it would be a concern if borrowers weren't telling the right information to the banks and the banks weren't verifying income statements'.⁷¹ He also noted 'APRA has standards about that and the banks' internal policies require them to verify income.'⁷²

- 2.54 The Governor added that APRA is undertaking work in this space:

What had been happening is that many banks had been assuming that the borrowers could live on relatively small amounts of money – much smaller amounts of money than in practice many people can live on. So there has been a concerted effort by the regulators to make sure that the banks are using appropriate expense calculations when working out what the size of the loans could be.⁷³

- 2.55 While noting that household debt in Australia is high, the Governor said that he is less concerned than he was in previous hearings with the committee:

I was quite worried; housing prices were rising very, very quickly – much faster than people's income – and the level of debt

68 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 25.

69 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 25.

70 Ms Michele Bullock, RBA Assistant Governor, Financial System, *Transcript*, 16 February 2018, p. 13.

71 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 22.

72 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 22.

73 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 22.

was rising much faster than people's income. And now we seem to be getting a better balance. We've got to keep an eye on it, because it could turn either way, but at the moment I feel the balance is much better than it has been for a few years.⁷⁴

- 2.56 The Governor was asked about inequality in Australia. He noted that 'wealth inequality has risen over a couple of decades', however 'the changes in Australia in recent times have been fairly small.'⁷⁵ The Governor remarked that while income inequality was not an objective of the RBA, 'it's something we pay close attention to, because the level of income inequality and wealth inequality affects how the economy operates.'⁷⁶ The Governor said:

The main thing we are doing to improve income equality is jobs generation, because nothing helps people like getting a job, does it? The fact that 400,000 people have got jobs over the past year has helped.⁷⁷

Housing

- 2.57 The RBA reported that house prices are cooling in parts of the Sydney and Melbourne markets, and have remained little changed in Perth and Brisbane.⁷⁸ The Governor explained that 'the increasing supply of housing, changes in the nature and availability of financing, and some reduction in foreign demand have all played a role here.'⁷⁹ He remarked:

While the Reserve Bank does not target housing prices or household debt, it would be a good outcome if we now experienced a run of years in which the rate of growth of housing costs and debt did not outstrip growth in income, as they have in recent years.⁸⁰

- 2.58 The Governor was asked if APRA's macroprudential measures were responsible for the recent adjustment in the growth of housing prices, particularly in Sydney and Melbourne. The Governor said that while APRA's measures had an impact, other factors have been weighing on house price growth:

74 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 8.

75 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 17.

76 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 17.

77 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 17.

78 RBA, *Statement on Monetary Policy*, February 2018, p. 2.

79 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

80 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 2.

There has been a very big increase in supply. The rate of growth of the number of dwellings in Sydney and Melbourne is the highest it has been for quite a few decades with all the construction that is taking place, particularly of apartments. So supply has gone up a lot. There has been less foreign demand as well. The Chinese tightened up capital controls, so it was harder for people to get money out of China, and state governments across the nation put up taxes on some foreign investors. So there has been some reduction in Chinese demand. There is also, ultimately, the weight of gravity: prices get so high that people find it very difficult to afford them – and I think that has happened in Sydney – and then that reduces demand.⁸¹

- 2.59 The Governor said that ‘the other dynamic on the housing market is that we have made choices as a society to give us high housing prices, on average, and that goes with high debt’.⁸² He explained:

The choices we've made are to live – most of us – in fabulous cities like this. We want large blocks of land – it's changing, but we've wanted large blocks of land – and we've underinvested in transport, so we've restricted the supply of well-located land. And we've got a liberal financial system and zoning restrictions. If you asked anyone how a country would deliver high housing prices, you'd find we've made all those choices.⁸³

- 2.60 Dr Ellis commented that much of the growth in housing supply in Melbourne and Brisbane has been in the inner city areas, while in Sydney growth has mainly occurred along the transport corridors. She said that the increase in supply has been mainly in apartments and noted ‘that is unusual in Australia.’⁸⁴

- 2.61 Dr Ellis also noted that improvements in transport have increased the supply of well-located land:

...once you've got good transport, it is now well located. So there has been a real phenomenon of the west and south-west fringe of Melbourne now becoming better connected to both the Melbourne CBD and Geelong. That whole conurbation is infilling, and that has enabled quite a strong increase in the detached housing supply in Melbourne.⁸⁵

81 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 7.

82 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 24.

83 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 24.

84 Dr Luci Ellis, RBA Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 12.

85 Dr Luci Ellis, RBA Assistant Governor, *Economic, Transcript*, 16 February 2018, p. 12.

Trends in the global economy

2.62 The Committee questioned the Governor on trends in the global economy, including the performance of Australia's major trading partners and volatility in financial markets.

2.63 In his opening statement, the Governor remarked that there is a 'synchronised upswing taking place' in the global economy:

Since we met last, in August, the improvement in the global economy has continued and forecasts for world growth have been revised up again. Rather than just one or two economies doing better, the improvement has been broadly based...Partly as a result of this, both international trade and commodity prices have picked up and both of these things are helping the Australian economy.⁸⁶

2.64 The RBA's February Statement noted that many of Australia's major trading partners have experienced a prolonged period of low interest rates, low inflation and low wage growth, similar to Australia.⁸⁷ The Governor remarked that, as a consequence of this, the recent pick-up in wage growth in the United States surprised many investors:

Over recent times many investors have been proceeding on the basis that this combination of strong growth, low unemployment, low inflation and low interest rates would persist. Many also expected the low volatility in asset prices to persist. A couple of weeks ago we saw a reassessment of some of these assumptions by at least some investors, with the catalyst being a pick-up in wage growth in the United States. The result has been an increase in bond yields, a decline in equity prices and increased market volatility.⁸⁸

2.65 The RBA reported that Chinese authorities are implementing measures to address risks in their financial system and Chinese money market rates have increased considerably in 2017. The RBA expects conditions in China's financial markets to further tighten in 2018.⁸⁹ The Governor commented:

Like other economies, China is benefitting from the global upswing. At the same time, though, there are ongoing efforts to increase the sustainability of Chinese growth, both in terms of its

86 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 1.

87 RBA, *Statement on Monetary Policy*, February 2018, p. 1.

88 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 1.

89 RBA, *Statement on Monetary Policy*, February 2017, p. 21.

financing and its effect on the environment. These efforts are affecting the structure of the Chinese financial system and they are affecting commodity markets. The Chinese authorities continue to face the difficult challenge of getting the balance right between containing medium-term risk and supporting near-term growth. We continue to watch developments there very carefully.⁹⁰

- 2.66 The February Statement noted that a period of low volatility in financial markets came to an end on 5 February 2018 when the Dow Jones Industrial Average dropped more than 1,500 points, representing its largest point decline in history during a trading day.⁹¹
- 2.67 The Deputy Governor, Dr Guy Debelle, said that the root cause for the increase in volatility was an improved global outlook, 'which is a good thing. Bond yields were starting to rise'.⁹² The Deputy Governor explained:
- If you go back a couple of weeks, bond yields started to rise mostly because the global outlook was looking even better, and wage pressure was starting to appear in the US, so bond yields were starting to rise. Equity prices have been very strong in the US – particularly strong in the US over the first part of this year, in January. If bond yields are going up then those equity valuations start to look a little stretched, and you started to see some of an adjustment to that. That generated a bit of volatility.⁹³
- 2.68 The Deputy Governor said that this situation was exacerbated by a number of investors buying up products, such as volatility protection, that were 'predicated on volatility staying low. When it didn't, they lost their money, and some of the people who'd sold them those products had to hedge.'⁹⁴ The RBA noted, however, that 'the rise in the price of volatility protection does not appear to have led to a disruption in the broader functioning of financial markets to date'.⁹⁵

90 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 1.

91 RBA, *Statement on Monetary Policy*, February 2018, pp. 25-6; CNN, *Stock Market Today*, 5 February 2018, <<http://money.cnn.com/2018/02/05/investing/stock-market-today-dow-jones/index.html>>, accessed 21 February 2018

92 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 23.

93 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 23.

94 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 23.

95 RBA, *Statement on Monetary Policy*, February 2018, p. 26.

International competitiveness

2.69 The Governor was questioned on Australia's competitiveness in attracting foreign investment, following recent corporate tax cuts in the United States. He noted that the key to Australia's success has always been its openness to international trade:

We benefit from foreign capital from the rest of the world, so we've got to be an attractive place for foreign capital, and people as well. It's been fundamental to our success to date, and I believe it remains fundamental to our success in the future.⁹⁶

2.70 The Governor remarked that, because of our need to attract foreign capital, 'Australia has more at risk here than many other countries from a decline in open markets and an increase in protectionism.'⁹⁷

2.71 The Governor was asked if he was concerned about Australia's competitiveness, given our headline and corporate tax rates are among the highest in the Organisation for Economic Co-operation and Development (OECD). The Governor noted that 'it is a competitive world out there, and other countries are using tax policy as a way of attracting capital investment'.⁹⁸ The Governor remarked:

It does look like there is a form of international tax competition going on. The US has moved. The UK has plans to lower its corporate tax rates, and a number of European countries do as well. And you can view this competition as good or bad. If you want lower taxes it's probably good. If you need to fund a budget then maybe it's not so good. So, whatever side of that debate you come down on, it is actually occurring, and it's hard to ignore.⁹⁹

2.72 The Governor said that 'if we were to respond to this competition by having lower corporate tax rates here then it's really important that that doesn't come at the expense of higher budget deficits.'¹⁰⁰ The Governor stated that 'he was comforted by the fact that the Budget is on a decent track.'¹⁰¹ The Governor said that recent corporate tax cuts in the United States have increased the budget deficit in the US to five per cent of GDP, 'largely on the back of the tax cuts' and that this was problematic.¹⁰²

96 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 6.

97 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 6.

98 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 27.

99 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 13.

100 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 13.

101 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 27.

102 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 13.

2.73 When asked if corporate tax cuts in the United States would have a positive impact on business and investor confidence, the Governor said that it has 'helped lift business confidence in the US'.¹⁰³ The Governor was less inclined to link strong employment growth in the last six months in the United States to corporate tax cuts and cautioned that, in the long term, the effects of the tax cuts are uncertain:

If you finance this through debt, those animal spirits can turn against you. It hasn't happened in the United States, but it's certainly a focal point for investors in where this is all going to end. The corporate tax cuts are sufficiently large that they've reduced the revenue base, and they're going to run much bigger budget deficits. Those animal spirits could turn the wrong way.¹⁰⁴

2.74 The Governor was asked if corporate tax cuts would lift global growth, given that countries such as the United States have revised up their growth forecasts. The Governor said corporate tax cuts can increase growth in the short term as a form of stimulus, since the government is taking less money out of the economy. However, he remarked 'in the longer term, if everyone cuts their corporate tax rates from here to here, do you get stronger global growth? Maybe. Maybe not.'¹⁰⁵

2.75 The Governor was asked about the government's forecast Budget surplus by 2020-21 and whether that gave him greater confidence as to the government's strategy concerning company tax cuts. He stressed the importance of returning the Budget to surplus in Australia, stating that 'I think we should keep on that track and shouldn't go and have a period of bigger budget deficits in a strong economy. So, if that is the track we are on, I'm confident.'¹⁰⁶ He said that returning to surplus was a matter of 'generational equity' as well as about preparing for the next economic downturn:

One day we will have another downturn in Australia and it'll be in the national interest to have a fiscal stimulus to offset that. We'll be able to do that effectively only if we've run a sensible budget policy in the interim. We saw during the financial crisis that those countries that had not run good budget policy actually had to contract fiscal policy in the crisis, making it worse. So, from an insurance perspective we need to make sure that we kind of remain broadly on that track.¹⁰⁷

103 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 18.

104 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 18.

105 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 24.

106 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 27.

107 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 14.

- 2.76 The Governor was asked if he was concerned about a possible credit rating downgrade. The Governor remarked that a credit-rating downgrade is 'more of a political event than an economic event', and explained that 'bond spreads would go up a bit, but not very much, and those higher bond spreads wouldn't be particularly problematic for the economy.'¹⁰⁸ However, the Governor also commented on the importance of maintaining a AAA credit rating, noting that a downgrade 'would matter, really, through the confidence channel.'¹⁰⁹
- 2.77 The Governor was questioned on the effect of energy costs on Australia's competitiveness in attracting foreign investment. The Governor commented that it was a significant issue but that Australia is still a desirable destination for foreign investors, highlighting 'the rule of law, the macro stability, the financial stability, our education system, our natural resources and our growing and diverse population.'¹¹⁰

Other issues

- 2.78 In his opening statement, the Governor updated the committee on the rollout of the New Payments Platform (NPP), which 'will allow Australians to make faster, simpler and smarter payments on a 24/7 basis'. The NPP, which was launched in early February, uses pay IDs rather than BSBs and account numbers. The Governor said that 'a major focus of the development effort has been security and to protect people from fraud'.¹¹¹
- 2.79 The RBA was questioned on issues of competitive neutrality in the design of the NPP, in particular whether it might adversely affect competition in the banking sector. Assistant Governor, Ms Michele Bullock, responded by explaining the design of the NPP:

The way the new payments platform is set up is that the larger institutions are in fact bigger shareholders; they've had to make larger contributions. Smaller institutions that want to participate have made smaller contributions in relation to the sorts of volumes they'll be using it at. And then lots of smaller institutions have opportunities to come in behind what we call aggregators. There are three main aggregators who are involved in the payments platform, and they link up hundreds of small credit unions and

108 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 6.

109 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 7.

110 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 20.

111 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 3.

building societies and banks behind them. So I would say that it is quite competitive in that sense. It's allowing equal and fair access to financial institutions that want to be involved in this system.¹¹²

- 2.80 The Governor was questioned on the rise and volatility in cryptocurrencies including Bitcoin, stating 'the one point that I've made publicly a number of times is that I think Bitcoin is speculative mania, and people should be very, very careful.'¹¹³
- 2.81 When asked if the RBA had any plans of developing a digital currency, the Governor explained that while the RBA had an 'open mind' in this issue, he did not think the public policy had been established, stating:
- The most likely use of distributed ledger technology for the central bank – and we've got an open mind about this – is the issuing of tokens into closed highly-permissioned systems that could then be used for efficient business-to-business processes.¹¹⁴
- 2.82 While noting that the RBA is doing some research into digital payment systems that use tokens, the Governor maintained that:
- The most efficient way to move money from account to account is through the existing banking system, rather than creating a new form of electronic liability that can be passed from electronic wallet to wallet.¹¹⁵
- 2.83 The Governor was asked whether Australia's financial regulators were working on the threat of climate change to the international economy, particularly the need for financial markets to allocate capital to manage climate change risks. The Governor said that the Council of Australian Financial Regulators had 'established a working group to look at these issues about disclosure'.¹¹⁶
- 2.84 Dr Debelle confirmed that disclosure is one of the main issues the working group (comprising APRA, the Australian Securities and Investments Commission, Treasury and the RBA) would be addressing.¹¹⁷

112 Ms Michele Bullock, RBA Assistant Governor, Financial System, *Transcript*, 16 February 2018, p. 13.

113 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 25.

114 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 26.

115 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 26.

116 Dr Philip Lowe, RBA Governor, *Transcript*, 16 February 2018, p. 11.

117 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 16 February 2018, p. 11.

Conclusion

- 2.85 Australia's economy has continued to grow in line with, or just above, the RBA's expectations. The RBA expects Australia's GDP growth to further strengthen over 2018 and 2019, reflecting a broader upswing in the global economy. This is being supported by low interest rates and the tax cuts for small and medium businesses that are already in place.
- 2.86 Australia's labour market has been especially strong. In the past year, 400,000 more jobs have been created, three-quarters of which are full-time. Labour force participation is close to its record high in 2011. We have had 16 consecutive months of employment growth, which is the first time that has happened in the history of the labour force survey.¹¹⁸ It is expected that continued growth in employment will further reduce spare capacity in labour markets and generate a gradual increase in wages and inflation.
- 2.87 In relation to the major banks' decision to increase interest rates on existing interest-only loans, the committee reiterates its view from the third report of its Review of the Four Major Banks.¹¹⁹ Banks should not be using macroprudential regulation, which is designed to reduce risks in the financial system, as cover for profiteering. The committee recommended that the Australian Competition and Consumer Commission, as a part of its inquiry into residential mortgage products, analyse the repricing of interest-only mortgages that occurred in June 2017. The Committee looks forward to the Government's response to the Committee's most recent report of the Review of the Four Major Banks, including its response to this recommendation.

Ms Sarah Henderson MP

Chair

9 April 2018

118 Dr Luci Ellis, Assistant Governor, Economic, *Transcript*, 16 February 2018, p. 21.

119 House of Representatives Standing Committee on Economics, *Review of the Four Major Banks (Third Report)*, December 2017, pp. 8-14.