

Monetary policy and other issues

Overview

- 2.1 The outlook for the Australian economy remains optimistic. The economy continues to perform well compared with other advanced nations. The strength of the current growth surge is expected to be sufficient to enable Australia to absorb the effects of both the catastrophic flooding across much of Eastern Australia and Cyclone Yasi without economy-wide difficulties.
- 2.2 The RBA calculates that the extreme weather conditions will reduce real GDP growth considerably in the December quarter of 2010 and the March quarter of 2011. The bank estimates that this will cut a full percentage point from its November 2010 forecast for real GDP by the end of the March quarter.
- 2.3 The stimulus of rebuilding homes, businesses and infrastructure damaged by either the widespread flooding or Cyclone Yasi is anticipated to contribute to a temporary rise in CPI inflation (probably to 3 per cent) for the forthcoming June quarter. The bank believes that this inflationary pressure will recede in the second half of 2011 and expire by the end of the year.
- 2.4 The RBA does not think that the extreme weather will disrupt Australia's long-running expansion or that the effects on prices constitute an obstacle to achieving the inflation target over the medium term, provided that the wider community understands that the effects on prices are purely temporary.

- 2.5 There are indications that global economic growth will be strong. The IMF forecast that global GDP probably grew by 5 per cent in 2010 and would grow by 4.4 per cent in 2011. China and India continue to grow strongly, while the rate of growth in the United States appears to have picked up. Conditions vary widely across Europe.
- 2.6 There has been a surge on global commodity prices across a range of goods – food, fuel, minerals and metals alike. In several countries these rises, especially in food, have caused a rise in the rate of consumer price inflation.
- 2.7 The medium-term outlook for Australia remains consistent with the RBA's analyses and forecasts for some time, that is, Australia continues to benefit from a terms of trade event of considerable significance, a once or twice in a century event. This has been balanced by the emergence of a new trend of greater caution regarding debt and enhanced rates of savings and debt repayment by the household sector. The increased caution of householders has placed the retail sector under distinct pressure, but the macroeconomic effect from restrained consumption at this time has been to preserve the economy from possible instability. The increased caution of householders may even prove salutary, as it adds a degree of resilience to household finances, should future developments prove unfavourable.
- 2.8 At its February meeting the board of the RBA decided that despite substantial impacts in the short term, it was nonetheless best that monetary policy not respond to either the expected stimulus from rebuilding or the expected price effects.
- 2.9 For its part, the RBA remains committed to the same framework for monetary policy that it has followed for the past two decades, keeping the growth of demand sustainable, so as to achieve an average underlying inflation rate of between 2 and 3 per cent.

Forecasts for the economy

- 2.10 Forecasts for the economy were published in the *Statement on Monetary Policy* on 4 February 2011. These were soon complicated by Cyclone Yasi. During the hearing the Governor advised that:

We had a stab at setting out some estimates in the *Statement on Monetary Policy* released the other day. That was finalised after we had seen the flooding in Central Queensland in December and more coastal flooding in January but before Cyclone Yasi had made landfall, so we could not assess that. I should emphasise that

all these estimates are preliminary and there is inevitably going to be a great deal of uncertainty around them. I think that will remain the case for some months.¹

- 2.11 These initial forecasts are available in Table 2.1. Growth for both the December quarter of 2010 in particular and for 2010 as a whole is likely to have been weaker than was previously expected. Retail spending has been subdued and coal production started to fall as a result of the flooding. Growth is expected to recover, as coal production returns to normal and as both households and firms replace damaged goods and capital equipment. Rebuilding, repairs and restoration work will all boost spending, though the effect of this will be spread across several years. GDP is expected to be back close to pre-flood levels by the June quarter. GDP is expected to grow by around 4¼ per cent over 2011. There is likely to be considerable variation across industries; the mining industry is expected to experience the strongest growth.²

Table 2.1 RBA Output and Inflation Forecasts (a)

Per cent, over year to quarter shown							
	<i>June 2010</i>	<i>Dec 2010</i>	<i>June 2011</i>	<i>Dec 2011</i>	<i>June 2012</i>	<i>Dec 2012</i>	<i>June 2013</i>
GDP	3.1	2¾	3¾	4¼	3¾	4	4
Non-farm GDP	3.2	2½	3¾	4¼	3¾	4	4
CPI	3.1	2.7	2½	3	2¾	3	3
Underlying inflation	2¾	2¼	2¼	2¾	2¾	3	3

Source Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p. 60.

- (a) Technical assumptions include A\$ at US\$1.00, TWI at 74, and WTI crude oil price at US\$96 per barrel and Tapis crude oil price at US\$103 per barrel. Sources: ABS; RBA

- 2.12 At the 11 February hearing the Governor reported that the CPI forecast in the most recent *Statement on Monetary Policy* needed revision on account of the expected effects of Cyclone Yasi, which would compound the effects of the earlier mass flooding. The Governor stated:

The result of that is likely to be a temporary rise in CPI inflation to probably around three per cent, we think, for the June quarter. That is a higher figure than was in the statement we released the other day because we have now factored in an effect from the cyclone that was not in that forecast. The combined contributions to that three per cent number of all the summer flood events and the cyclone is probably half a percentage point or maybe even

1 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 3.

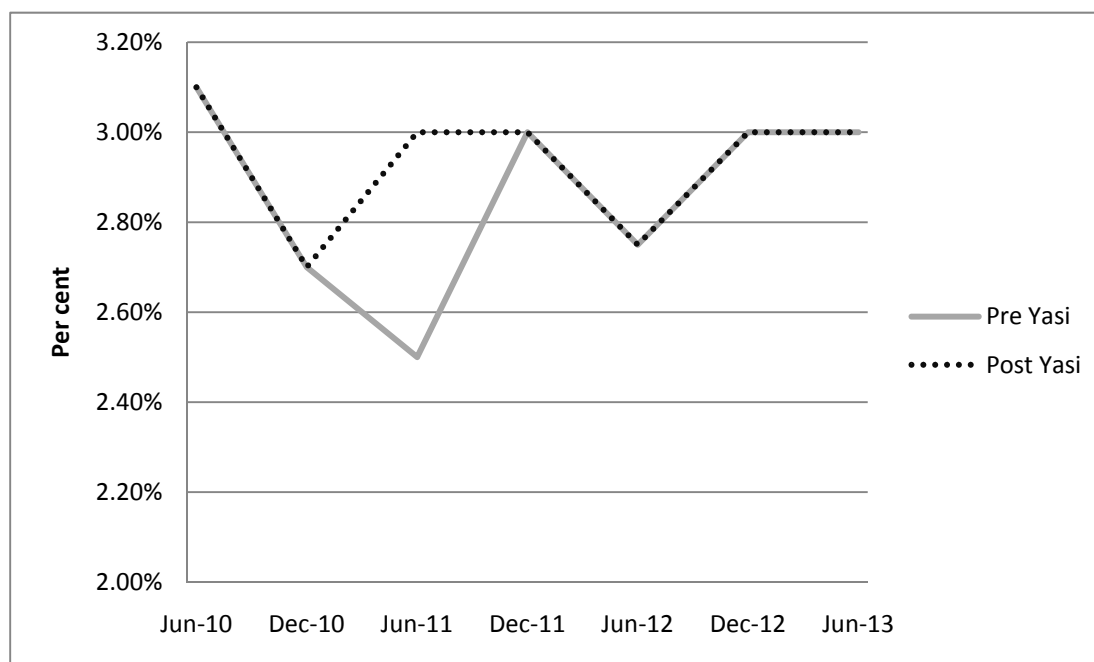
2 Reserve Bank of Australia, *Statement on Monetary Policy*, 4 February 2011, p. 60.

slightly more. These effects should begin to reverse in the second half of the year and should be largely gone by the end of the year, we think.³

- 2.13 Figure 2.1 below compares the initial, pre-Yasi, forecast for CPI inflation and the revised forecast, as advised at the hearing. The Governor did not advise the committee of a precise figure for the slump in real GDP for the December quarter of 2010 itself, though he did indicate that by the March quarter the figure could be a full percentage point lower than the figure cited at the last hearing, which was in November 2010.

Figure 2.1: RBA CPI Inflation Forecasts, pre and post Yasi

Per cent, over year to quarter shown



Source Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p. 60 and Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p.4

3 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 4.

2.14 The Governor explained the forecasts thus:

...the estimates we put together suggest that real GDP will be noticeably lower than it would have been in the absence of these events in the December and, particularly, the March quarters. By the March quarter, we think it could be about a percentage point lower than the forecast we had when we were last here. As to the reasons for those effects, it is...mainly because the economy's capacity to supply goods and services, particularly certain commodities, has been seriously disrupted. It is likely that the bulk of those supply losses will be recovered in the June quarter as production, particularly in coal mining, which is a very big swing factor here, resumes. Nevertheless, for many businesses there has been a period of lost income and the reduction in the level of GDP on average for the year of about half a per cent – this is the number that the government quoted and we have roughly the same figure...⁴

2.15 The bank's forecasts for the global economy were not affected by the weather disturbances in Australia, though the disruption to coal production was of global significance. In the *Statement on Monetary Policy* the bank advises that it expects that the world economy would expand over the next couple of years just above the annual trend of 4¼ per cent. Strong growth is expected in China and India, with steady growth elsewhere in Asia, with the exception of Japan, where growth is expected to be slower than in 2010. The United States and the euro area are expected to recover at a moderate pace in the United States and in the euro area as a whole. The advanced economies will maintain 'considerable excess capacity...in contrast to most emerging economies', while uncertainties concerning the sovereign debt problems in Europe and the response to these in much of Asia will endure.⁵

2.16 The bank expects that global growth will have a positive impact on Australia. Commodity prices have increased since the November hearing of the committee. Spot prices for coking and thermal coal have also increased, due in part to significant disruptions in supply as a result of the Queensland floods and unseasonably cold weather in the Northern Hemisphere. Demand from China and tight global supply has exerted upward pressure on iron ore spot prices. Global food prices have also started to increase significantly over recent months. The combined impact

4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 3.

5 Reserve Bank of Australia, *Statement on Monetary Policy*, 4 February 2011, p. 59.

of these has meant a further upward revision to forecasts concerning Australia's terms of trade over the near-term.⁶

2.17 The bank expects that the economic consequences of Cyclone Yasi are likely to be temporary. While the cyclone has done major damage to some crops, the bank has received intelligence that indicates that the overall damage may not be as extensive as that of Cyclone Larry five years ago and that the rate of recovery may be higher. Despite this, there has been a substantial impact, with a large rise in the prices of some crops already taking place. This compounds the price increases resulting from the earlier floods.⁷

2.18 The overall situation remains essentially positive. As the Governor observed:

...to take the broader picture, underlying inflation has fallen substantially from its peak in 2008. It needed to, but it has. And I think it is worth recording that, on the latest numbers we have, we have an unemployment rate of five per cent and an inflation rate clearly in the twos, which is where we want it to be. That combination, when you go back and look at recent decades, actually is a pretty favourable one compared to many that we have had.⁸

Inflation

2.19 The Governor counselled that the medium-term inflation outlook is largely unchanged and the RBA expects that things will remain as expected for the forthcoming two years. The near-term picture is a little lower, because of the history behind the low figure achieved, while the CPI is higher as a result of the floods, which is a temporary effect. Essentially, the 'policy is about right'.⁹

2.20 The Governor warned the committee about the significance of expectations about inflation:

The assumption we are making...is that people's expectations of the permanent inflation rate do not go up. I do not think they will actually. We have seen these sorts of things before. People understand that. People correctly sense that prices of fruit and vegetables and so on are going to go higher for a while. The

6 Reserve Bank of Australia, *Statement on Monetary Policy*, 4 February 2011, p. 59.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 4.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 4.

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 6.

damaging thing would be if they took that to mean that inflation everywhere is going to stay high permanently. Then we have got a problem, because it is not so easy then to say that monetary policy should not respond to that. It would have to if that turned out to be the problem.¹⁰

2.21 At present the RBA is confident that the experience of Cyclone Larry will be repeated; that the public will not develop long-term expectations of inflation on the basis of a temporary spike in the price of fruit and vegetables.¹¹

2.22 Continuing a line of inquiry from the previous hearing, the committee referred to comments that the Governor had made about the price increases in utilities being linked to underinvestment and asked him what is going to retrieve the situation. The Governor denied any great expertise in water and electricity, but emphasised that producers 'need to be able to get a price for their product which covers their capital costs and returns' and that 'I do not think we will get an efficient allocation or usage of those things if we do not price them right.'¹² Dr Lowe explained the precise causes of the price increases:

The major price increases that we are experiencing at the moment for electricity are not coming about because of higher generation costs. They are coming about because of the investment in the distribution network...demand for electricity has grown but the spikiness of electricity demand has grown as more and more people have got air conditioning. We have not built enough transmission infrastructure to deal with those spikes. So the electricity authorities are having to spend a huge amount of money building the transmission or rebuilding and repairing and expanding the transmission network. We have not seen, at least to date, large increases in utility prices come primarily from generation costs. In time I think we will, but at the moment it is really about the networking, the distribution expansion that is going on.¹³

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 8.

11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 8.

12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 16.

13 Dr Philip Lowe, Assistant Governor, Economic Group, *Transcript*, 11 February 2011, p. 16.

Queensland and capacity constraints

- 2.23 The committee sought the Governor's advice about the impact that the floods in Queensland, plus Cyclone Yasi, would have on the economy, in particular what pressures they would add to emerging capacity constraints. The Governor stated that he expected that the rebuilding would slow down alternative areas of spending, while the construction of new dwellings would utilise existing spare capacity, of which there was plenty in South-East Queensland.¹⁴ The bank believes that the damage inflicted by the extreme weather conditions needs to be understood within the context of the size of the economy as a whole. Dr Lowe referred to the most recent edition of the *Statement of Monetary Policy* in which the RBA forecast an additional \$8 billion of spending for repairs and infrastructure rebuilding and counselled that this figure contrasts with one of \$1.4 trillion for the entire economy.¹⁵

Global economy

- 2.25 The Governor advised that the global economy appears to be stronger than when he last testified before the committee, that China and India continue to expand at a strong rate and the United States appears to have increased its rate of growth. However, problems remain: conditions across Europe are varied and the relationship between sovereign and bank creditworthiness has not been resolved.¹⁶
- 2.26 The Governor noted that the IMF now estimates that world GDP growth was about five per cent in 2010. This exceeds the 30-year average. The IMF forecasts global growth of 4.4 per cent in 2011. This is significantly above the average pace of growth. In addition, global commodity prices such as metals, minerals, energy and food have all risen. Inflation is likely to become a major issue in international economic policy.¹⁷
- 2.27 The recent surge in global coal prices was, at least partially, a reflection of Australia's significance as an exporter; the recent floods in Queensland appear to have reduced national production by about 15 per cent, and that has a material impact on the global supply of traded coal. The price of iron ore has risen above the highs of 2008, though in this case the principal driver was strong demand.¹⁸

14 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 8.

15 Dr Philip Lowe, Assistant Governor, Economic Group, *Transcript*, 11 February 2011, p. 8. Readers should note that the \$1.4 trillion figure is metric, so equals \$1,400,000,000,000.

16 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 1.

17 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 2.

18 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 2.

- 2.28 The net result of all this is that Australia's terms of trade are higher than previously assumed and the RBA expects that they will peak both higher and later than was previously expected. Capacity in the production of iron ore, natural gas and coal is scheduled to expand in the near-term. A number of new proposed projects (especially in the natural gas sector) have received permission to proceed.¹⁹
- 2.29 The Governor confirmed that Australia is 'experiencing a terms of trade event of a very large size, of the type that happens only once or twice in a century'. The key task for policy makers is to avoid the instability that has typically accompanied such episodes before.²⁰
- 2.30 In discussion with the committee about the global economy, the Governor teased out a key question: 'how does Australian monetary policy handle something that has a global origin?' The Governor answered this by stating that:
- ... as a country that in the long run has an independent monetary policy with its own currency and a floating exchange rate, we are able to generally chart our long-run destiny ourselves but, of course, we have to let the exchange rate move to do that...We have our own currency area, our own monetary policy and our own inflation target. It makes it harder to contain inflation when you are getting these global shocks...but we do a lot better than we would otherwise by allowing our currency to go up if it wants to and keeping the focus on controlling inflation over the medium term...It is not perfect but it is the best model there is that I know of.²¹

Exchange rate

- 2.31 The Governor notified the committee that the exchange rate is very high, indeed is now 'at a peak level for the floating era, since 1983'.²² Given the terms of trade, this is unsurprising, but, the Governor warned that, 'it is exerting a dampening pressure on the traded sector of the economy outside the resource sector.'²³
- 2.32 The committee asked about the underlying philosophy of the RBA's foreign exchange transactions. The Governor replied that the philosophy

19 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 2.

20 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 2.

21 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 31.

22 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 5.

23 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 5.

is to intervene only in moments of exchange rate extremes or in very disorderly markets. Such conditions are not common and once they are over the RBA seeks to return the reserve balance to normal. According to the Governor, 'we are not frequent interveners and we are not fine-tuners of the exchange rate, but if we think that there is a significant misalignment and disorderly markets we are prepared to act quite aggressively on those occasions'.²⁴

Multispeed economy

2.33 The committee was concerned about the existence of a multispeed economy and the differential impact of interest rates on the various areas of the economy, some of which were not faring as well as the mining sector. The committee asked the Governor if interest rates were a blunt policy instrument on an economy-wide basis. The Governor agreed that they were, but advised that there were 'not very many sharp instruments of macroeconomic policy...when you think about it'.²⁵ In addition, monetary policy is inevitably developed with regard to the economy-wide average. There is no alternative to this.

2.34 The Governor acknowledged the reality of varying levels of advantage and disadvantage by region and industry, but asserted that:

If we want to address regional differences or industry differences it has to be other policies that do that, and they are going to be in the preserve of governments in terms of spending measures...It is going to be important though...that those sorts of measures have a strong focus on helping people adjust rather than trying to prevent adjustment, because we are not going to be able to prevent at least some adjustment in the structure of the economy...Those instruments of course are not in our hands—they are in the parliament's hands, really.²⁶

2.35 The committee proposed a hypothetical situation in which the states maintained their own monetary policies and reserve banks. The Governor acknowledged that this was an issue and referred to a speech that he had given in Shepparton on the subject.²⁷ The Governor then maintained that the underlying issue was not really a conflict of interest between different states at all:

24 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 19.

25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 28.

26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, pp. 28-29.

27 Mr Glenn Stevens, *Monetary Policy and the Regions*, 20 September 2011; accessed on 14 November 2011 at <http://www.rba.gov.au/speeches/2010/index.html>.

But the essence of the problem is that it is not just Queensland versus other bits of Australia. It is bits of Queensland versus other bits of Queensland, and ditto in Western Australia...²⁸

- 2.36 The Governor reassured the committee that he was aware of the disparate distributional effects of changes to the cash rate and interest rates and that he receives substantial communications directly from Australians on this matter.²⁹

Capex and other stimuli

- 2.37 The committee noted that private sector capex (capital expenditure) is forecast to be around \$780 billion and that this is the largest capital expenditure the Australian economy has experienced for some time. The committee asked the Governor if the RBA would have to manage the combined effects of state, public and private sector spending by raising interest rates. The Governor advised that the fiscal stimulus from the federal government was easing and that:

The announced plans for federal fiscal policy are that the stimuluses that were put in place as a result of the decisions back in late 2008 and early 2009 have come through and are now tailing off, so, strictly speaking, I think the fiscal impacts as conventionally measured would be going negative in the current fiscal year or, if not, very soon.³⁰

- 2.38 When the committee sought to explore a possible link between previous interest rate rises and the federal fiscal stimulus of recent years, the Governor stated that:

What they are tied to is that we had a very expansionary setting of monetary policy, the lowest cash rate in 50 years, to meet what was at that time perceived – and I think rightly – as a huge threat given the global situation, and then the worst did not come to pass. We had a modest downturn. We were into recovery quite quickly. And we said, ‘Well, monetary policy should go back to normal once the economy is clearly on its way back to normal,’ which it was, so we normalised. And now, of course, we are a little bit on the tight side of normal, looking forward to the forces that we think are already building up. Demand turned out to be, in the

28 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 29.

29 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 29.

30 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 10.

private sector, stronger than we had feared it would. We feared it would be weaker.³¹

- 2.39 The Governor advised that the eventual result of this approach was an incredibly good one. During further discussion on interest rates the Governor analysed comments by the committee and teased out the question: 'would rates have been lower if the fiscal policy had been tighter?' The Governor responded by stating that this question had been asked many times before and that the answer was that they would have been lower, but that this would not necessarily have been a better outcome.³²

Household debt

- 2.40 The Governor reported that the ratio of household debt to income appeared to have stopped rising, after having risen for about 20 years.³³ A similar trend is apparent in a number of other countries. The Governor stated that Australians have the good fortune to consolidate their finances while incomes are rising (largely due to the terms of trade). This is not the case with many other countries.
- 2.41 The committee sought advice from the Governor on how Australia sits with respect to household debt and interest payments against disposable income, especially compared with households in America, Canada and the United Kingdom. The Governor explained that twenty years ago the debt to income ratio in Australia was low by the standards of developed countries and that now it is high. The Governor stated that there were reasons 'why we should not always assume that really low rates are good, because that is one of the things that can prompt people to build up much more debt than maybe they really should'.³⁴ In addition, he noted that in some peoples' view it was precisely the accessibility of cheap money that prompted so many American households to get into trouble.³⁵
- 2.42 Asked about how the costs of servicing debt in Australia compared to other countries, the Governor replied that:

Our interest rates are relatively normal, whereas in a number of other countries their cash rates are certainly extremely low. Their actual borrowing rates are not as low because the long rates drive

31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 11.

32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 11.

33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 3.

34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 12.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 12.

the borrowing rates. We have rates of servicing costs that have gone up materially in a trend sense over time, reflecting the amount of debt people have taken on.³⁶

- 2.43 The Governor also reported that there was a trend towards greater caution concerning household debt in Australia. He noted that the rate of saving out of current income has risen for several years past, though he warned that the measurement of saving is not necessarily an entirely accurate figure, 'being the residual between two very large aggregates'.³⁷ Yet it would appear that Australians are increasingly seeking to reduce their debts.
- 2.44 The committee was anxious to clarify why Australian patterns of debt were changing. The Governor advised that Australians may have become more cautious as a result of the experience of debtors in other economies. The Governor suggested that 'in the long run we might be moving to a structure of household finances and saving that is a lot more robust to adverse shocks to income, which one day will hit us from somewhere.'³⁸ The Governor was at pains to explain that he was not describing any fully-developed hypotheses, but was simply giving his impressions. He explained that data was only available for recent years.
- 2.45 Dr Lowe advised that the use of credit cards has slowed down, while the rate of payments on housing loans has sped up. He also noted that various consumer surveys have exposed changing attitudes to spending and buying. This is consistent with increases in bank deposits. According to Dr Lowe there is sufficient circumstantial evidence to conclude 'that there is something fundamental going on'.³⁹ It is unclear, however, if this trend will continue.
- 2.46 The committee asked the Governor if the RBA had a preferred level of savings or a preferred attitude to debt. The Governor expressed his reluctance to identify a specific target for savings, explaining that for a while the rate of saving was so low that the ABS (which takes depreciation into account) calculated that it was actually negative and that:

...we were collectively saving nothing out of the current income.
We were gearing up balance sheets to own houses, basically, and

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 12.

37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 2.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 24.

39 Dr Philip Lowe, Assistant Governor, Economic Group, *Transcript*, 11 February 2011, pp. 24-25.

spending all of our current income. Historically, that is very unusual.⁴⁰

- 2.47 The Governor elaborated by stating that he did not believe that debt was inevitably a bad thing, but that the volume of debt accrued by Australians was quite high and that a disproportionate part of it was accrued by high income earners, rather than low income earners. The rate of saving out of current income is at 9 or 10 per cent. The Governor thought that this was not necessarily optimal, but is nonetheless closer to where the bank would expect it to be over the long run and certainly preferable to a rate of zero savings.⁴¹

Cash rate

- 2.48 The committee asked the Governor whether interest rates were on hold for the foreseeable future. The Governor replied by asking, rhetorically, 'how long is the foreseeable future; how long is a piece of string?'⁴² The Governor insisted that the RBA did not anticipate any change in the cash rate for some time. However, circumstances may well change, requiring changes to interest rates.

- 2.49 The committee was interested if there were any arguments for easing rates, given the RBA's inflation forecast and the Governor's statement about interest rates being a bit above average. The Governor explained that:

I think it is about right for them to be where they are, given that we have a once-in-a-century terms of trade event that is very expansionary and all the things that flow from that. It would be surprising if you did not have to have policy a bit on the tight side of normal in that event, taking account of the fact that the exchange rate is doing a fair bit of work for us. I think there would only be an argument for an easing if that strength looked like it was significantly dissipating or if we had some other very important piece of news that was quite view changing.

- 2.50 The committee sought the Governor's comments on the spread between the RBA cash rate and the variable mortgage rate, since the 10-year average was around 180 and is now about 300. The Governor explained that:

40 Mr Glen Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 25.

41 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February, 2011, p. 25.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February, 2011, p. 5.

We are talking about a rise of a hundred points or a little more, give or take, depending on which exact product you are talking about over the three years since about the middle of 2007. That reflects the fact that the market funding costs across a range of sources have moved up materially compared to the overnight cash rate, which is why the overnight cash rate is considerably lower today than it would normally have been in these sorts of circumstances. It is to take account of that difference. I think we have said that pretty clearly many times.⁴³

Labour market and wages

- 2.51 The committee wished to determine if the relationship between vacancies and unemployment was deteriorating or improving. The Governor stated that:

The vacancy rate as a share of the labour force is on the way up...One might say as a result of all that that we are pretty close to full employment. At one level that is good, isn't it? We are supposed to try to have full employment. We do not want to be over full, so we do not want to have serious pressure on wages and inflation. We do not want to have serious skill mismatch, which might be another issue to talk about.⁴⁴

- 2.52 The Governor also advised that the RBA liaison indicates that while the labour market in the resource sector was tightening up 'employers are not really finding serious problems just yet'.⁴⁵ Dr Lowe confirmed this, stating that 'when we talk to firms we are not detecting that they are having to compete incredibly aggressively to get workers to fill those jobs...firms do not seem to be saying that it is particularly hard to find workers at the moment.'⁴⁶

- 2.53 The committee also sought to find out about wage pressures, especially in the resources sector. The Governor stated:

There is pressure on wages there. You would expect that... I do not think it is especially worrying in itself. The macro question really is: does that engender pressure right across the economy in due

43 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 12.

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, pp. 17-18.

45 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 18.

46 Dr Philip Lowe, Assistant Governor, Economic Group, *Transcript*, 11 February 2011, p. 18.

course that is too great or not? At the moment, I think we are travelling okay.⁴⁷

- 2.54 The committee also inquired about the possibility of a wages break out as a result of changes to industrial relations regulation. The Governor insisted that the evidence was not yet available to give an answer to that question and that we would only find out in the next two to three years.⁴⁸

Bank competition

- 2.55 The committee sought to take stock of banking competition, noting constituency feedback that there appears to be less banking competition than before and that bank profits are at record levels. The committee explored this matter in connection with the near doubling of the spread between the cash rate and the standard home loan variable rate. The Governor responded that the important indicator is the banks' overall interest margins, because the long-run story is that while they were 500 points in the early nineties, they are now between 2¼ and 2½ per cent. According to the Governor, 'the long-run big story is that those margins are actually much skinnier today than they were historically.'⁴⁹
- 2.56 The Governor elaborated, stating that the change was a consequence of more transparent pricing and the reduction in banks' costs. The Governor went on to note that while bank competition in the mortgage market is not as intense as it was two or three years ago, there remains a great deal of competition in the banking sector. This competition is most evident when it comes to raising money in deposits. When funding was readily available in the past, there was pressure to lend. One result of global developments is a greater degree of competition from banks competing with other banks for deposits. Essentially the locus of competition has shifted from lending activity to attracting deposits.⁵⁰
- 2.57 This advice was endorsed by Mr Battellino, who pointed out that there are all sorts of other factors affecting cost of funds to banks. According to Mr Battellino, the key point is that net interest margins have not really changed in five or six years: the banks move their lending rates in line with their cost of funds.⁵¹

47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 37.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 38.

49 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, p. 12.

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 11 February 2011, pp. 12-13.

51 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 11 February 2011, p. 13.

- 2.58 Committee members stated that they had difficulty in reconciling lower volumes of commercial activity with record bank profits. Mr Battellino responded by explaining that one ‘cannot look at things in terms of dollars because everything is rising in dollar terms’ and that the return on equity of banks is actually lower than it was several years ago.⁵²

Conclusions

- 2.59 Australia continues to have good reasons for considering itself ‘the lucky country’. Despite the significant, unquantifiable, human costs of the recent natural disasters, the material costs are readily manageable, given the size of the economy and the vigour and duration of the various drivers of growth.
- 2.60 Australia continues to benefit from exceptional terms of trade, the likes of which we appear to experience once or twice in a century. While we must be cautious about the development of capacity constraints and other possible inflationary pressures, at this stage there is no pressing need for concern.
- 2.61 Monetary policy remains on track to meet the goals of its long-standing policy of maintaining inflation within the 2 to 3 per cent band over the medium-term.
- 2.62 The next public hearing is scheduled for 26 August 2011 in Canberra.

Craig Thomson MP
Chair
23 March 2010

52 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 11 February 2011, p. 13.