The Parliament of the Commonwealth of Australia

# Review of the Reserve Bank of Australia Annual Report 2011 (First Report)

House of Representatives
Standing Committee on Economics

March 2012
Canberra

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# Chair's foreword

Australia continues to enjoy near-ideal conditions by every relevant measure of international comparison. Despite the disturbing persistence of uncertainty throughout much of the global economy, especially the Eurozone, the fundamentals of the Australian economy remain strong. Our public debt and unemployment rate are low by international standards. Our underlying inflation is at the midpoint of the inflation target range. We remain an attractive location for a wide range of both foreign and domestic investors. We are well-placed to benefit still further from the current historic surge in business investment, particularly in the resources sector. This surge assures Australians of still more growth in output and national wealth.

As this report demonstrates, the RBA's central expectation for the next two years is for growth to closely follow the trend and for inflation to be close to the target. This is no mere extension of previous growth, but evidence of a fundamental realignment within the national economy. As the bank has testified, the drivers of growth in our economy have changed quite recently. The long-term, structural, effects of the export oriented resources boom are now working their way through the nation, across region after region. The resulting investment boom continues to grow in strength. This is expected to last for the foreseeable future, though it has already taken the share of business investment in GDP to its highest level in at least 50 years.

It is now clear that household behaviour has changed, with Australian households taking advantage of the current condition to save more and spend less than they have done in the recent past. This will provide Australian families with an enhanced degree of financial resilience.

At the last hearing in February the committee expressed its very best wishes to Mr Ric Battellino on the occasion of his retirement as Deputy Governor and our congratulations to Dr Philip Lowe on his new position as Deputy Governor.
I would like to reiterate those sentiments here.

Finally, 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 24 February 2012. The committee will conduct the next public hearing with the RBA on 24 August 2012 in Canberra. Further details will be circulated in the weeks prior to the hearing.

Julie Owens MP
Chair

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# Membership of the Committee

| | |
|---|---|
| Chair | Ms Julie Owens MP |
| Deputy Chair | Mr Steven Ciobo MP |
| Members | Mr Scott Buchholz MP |
| | Mr Stephen Jones MP |
| | Dr Andrew Leigh MP |
| | Ms Kelly O'Dwyer MP |
| | Mr Craig Thomson MP |
| Supplementary Members | Mr Adam Bandt MP |
| | The Hon Tony Smith MP |

# Committee Secretariat

| | |
|---|---|
| Secretary | Mr Stephen Boyd |
| Research Officer | Dr Phillip Hilton |
| Administrative Officer | Ms Natasha Petrović |

# 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.

# List of abbreviations

| | |
|---|---|
| CPI | Consumer Price Index |
| GDP | Gross Domestic Product |
| IMF | International Monetary Fund |
| RBA | Reserve Bank of Australia |

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# 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 *Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Wayne Swan, 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 has also indicated that he plans to continue the practice of making himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics.
>
> The Treasurer expresses support for the continuation of these arrangements, through which the transparency and accountability of the Reserve Bank's conduct of monetary policy are in line with international best practice. These arrangements enhance the public's confidence in the independence and integrity of the monetary policy process.[1]

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1 Reserve Bank of Australia, *Statement on the Conduct of Monetary Policy*, 30 September 2010.

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

## Scope and conduct of the review

1.4 The fourth public hearing of the committee with the RBA during the 43rd Parliament was held in Sydney on 24 February 2012.

1.5 The audio 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 Ms Su-Lin Ong, Managing Director, Head of AU/NZ Economics & Fixed Income Strategy, RBC Capital Markets. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Ms Ong's cooperation and assistance.

1.7 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. The committee welcomes the Governor's frank and open comments at the hearings. In addition, the hearings are an important means whereby financial markets can be better informed on the current thinking of the RBA.

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

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2 See: <http://www.aph.gov.au/economics>

3 See: <http://www.rba.gov.au>

## Next public hearing with the Reserve Bank of Australia

1.9 The committee will conduct the next public hearing with the RBA on 24 August 2012 in Canberra. More details will be circulated in the weeks leading up to the hearing.

# 2

# Monetary policy and other issues

## Overview

2.1 Since the committee's previous public hearing in August 2011, the focus of concern has been on the possible impact of sovereign debt problems in Europe. High levels of public debt in key nations, caused a 'palpable fear before Christmas that Europe was on the brink of some sort of very bad financial event'.[1] The period was characterised by a flight from risk with borrowing costs for major nations like Spain and Italy rising, but falling to their lowest level in more than 50 years for the United States and Germany.

2.2 The Governor of the RBA reassured the committee that:

> The anxiety has not gone away altogether—and nor will it, I think, for some time—but the worst has not happened. Financial markets, while hardly brimming with confidence, have recovered somewhat over the past couple of months. Banks are able to access term funding again, albeit at higher cost. High-frequency gauges of business conditions and confidence have stabilised over the past few months in Asia, in North America and in fact even in Europe. We have not seen the very steep fall in all these indicators that we saw late in 2008.[2]

2.3 The Governor explained the improvement in conditions as the result of the European Central Bank having stabilised financial conditions through addressing questions about the funding of European banks, as well as the

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1 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

efforts of European leaders to establish a stronger fiscal framework for Europe.[3]

2.4 The Governor emphasised that that the global situation remains mixed:

> If we look for things to worry about, we will certainly find them. That global figure has a very uneven composition and there are some countries, particularly in Europe, which will record very weak outcomes this year. Moreover, it is unlikely, I think, that any time soon we will get to a moment at which it can be said that these problems in Europe are now behind us. Most likely progress will be slow and there will be periodic setbacks and bouts of heightened anxiety. I think that is just the nature of these things.[4]

2.5 The Governor put this in context by pointing out that the global situation has not been consistent. While growth has slowed in Asia, it has not slumped. The US economy avoided a 'double dip' recession and has continued to grow. The US corporate sector has performed very strongly and looks set to make more rapid progress in the future. US corporations appear to have increased the rate at which they hire new staff.[5]

2.6 Despite the current international uncertainty, the fundamentals of the Australian economy are strong. Public debt and unemployment are low, underlying inflation is at the midpoint of the inflation target range, and we have a significant pipeline of business investment, particularly in the resources sector.

2.7 In relation to Australia's performance and economic outlook, the Governor stated:

> Our rate of unemployment has a 'five' at the front and the next digit is a small number. Inflation is about where we want it and our banks are strong. Our government finances, despite some pickup in debt in recent years, are that basically we are a AAA-rated country and rightly so—there are not that many of those. We are attractive to foreign investment. The government did not end up having to own any banks as a result of the crisis. There is a lot that is good about that picture. I do not wish in any way to be a Pollyanna and say, 'Look, it's the best of all possible worlds,'—it is not. We have issues, but it is actually a pretty reasonable performance compared both with our historical experience and

3 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 1-2.

5 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

> also with the vast bulk of other countries you might choose with which to draw a comparison.[6]

2.8 The RBA's central expectation for the next two years is for growth to closely follow the trend and for inflation to be close to the target. The Governor emphasised that the drivers of growth in the Australian economy have changed recently. The Governor commented that 'we have spoken at length in the past about the terms of trade, the resulting investment boom, which is still building and has somewhat further to go yet and which will take the share of business investment in GDP to its highest level in at least 50 years.'[7] The Governor also noted that household behaviour has changed with people saving more and spending less.[8]

2.9 The overall effect is that while the economy has experienced average growth, this has been distributed unevenly. There are sectors of the Australian economy which are experiencing average performance. Some are weak relative to the historical average, others stronger. The Governor acknowledged that:

> The bank is quite aware of those differences and the pressures that they bring to businesses and individuals. We also know that monetary policy cannot remove the forces that generate different paces of growth across industries or regions in the economy. We have to keep our eye on the overall performance of demand and prices. We are also acutely conscious that history may offer limited guidance in assessing the net impact of the very disparate and very powerful forces which are at work to an extent which has seen few historical parallels.[9]

2.10 For these reasons, the bank decided that the existing monetary settings were appropriate for our present condition and were 'about right for the moment.'[10]

2.11 The Governor was asked about the robustness and resilience of the Australian economy to respond to another significant downturn like the Global Financial Crisis in 2008. The Governor responded in the affirmative, declaring that:

> I think that in the banking sector we are probably in better shape than then because of the extent of usage of wholesale funding.

6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 4.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 2-3.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.

> There is still a considerable amount of it, but it was smaller than it was then. Asset quality and capital is strong...I think we would be in good shape...we have as much capability as any country and more than most to respond to it.[11]

# Forecasts for the economy

## Forecasts for the global economy

2.12 Though sovereign debt remains an enduring problem in Europe, sentiment has recently improved in response to measures taken by the European Central Bank and European governments. Equity and commodity prices have risen, while bond yields in several European countries have fallen. Further work will be needed to ensure the sustainability of European public finances.[12]

2.13 Official forecasts for global growth have been revised down. Global growth is now expected to be below trend in 2012, though not as weak as in 2008–09. Much of the growth is expected to come from the emerging market economies, especially in Asia. A broadly synchronised fiscal consolidation throughout the developed economies is expected, as households and financial institutions deleverage. This reduces growth, so unemployment in these countries is not expected to fall in the immediate future.[13]

2.14 Much of Europe appears to be in recession, though the US economy has picked up following a soft patch in mid 2011, with unemployment falling and an apparent improvement in the housing sector. Weaker exports have caused growth to slow in East Asia. Both growth and inflation has fallen in China, as per the intention of official policy there. The Chinese authorities have been trying to contain property prices, with some success.[14]

2.15 Though the spreads on many European bonds remain elevated, they are lower than in late 2011. In Australia, yields on 10-year government bonds have recently fallen to 50-year lows, following significant purchases by

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11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 4.

12 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1. This is available electronically at: http://www.rba.gov.au/publications/smp/2012/feb/pdf/0212.pdf

13 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.

14 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.

non-residents, including sovereign asset managers. The Australian dollar continues to appreciate against major currencies and is currently just below the multi-year peaks reached last year.[15]

2.16 Following concerns over the European banking system in much of 2011, there was very little bank debt issued for sale. Rates of issuance have improved recently, but spreads on bank debt are much higher than in mid 2011. Some large corporations now raise funds in the capital markets more cheaply than banks with a higher credit rating. This has had an effect on Australia, where the banks' overall cost of funding relative to the cash rate has risen.[16]

## Forecasts for the Australian economy

2.17 Commodity prices after falling over the second half of last year have recently risen. The price of iron ore has increased thanks to strong demand from China, despite the fact that global steel production has fallen. Thanks in part to geopolitics, energy and commodity prices have remained at high levels.[17]

2.18 Australia's terms of trade reached a record high in the September quarter, but declined in the December quarter of 2011. Australia continues to grow at a moderate rate. GDP is estimated to have increased by around 2¾ per cent over 2011. This is a little below average. Conditions vary across industries, as the economy experiences structural change as a response to high commodity prices and the exchange rate.[18]

2.19 Real incomes for Australia have risen as a result of the terms of trade, but the effects are unevenly distributed. The various measures of business conditions and confidence are now at, or just below, average levels.[19]

2.20 Business credit has also increased a bit during the second half of 2011 after it had fallen in the previous year. Credit conditions remain tight for commercial property. Investment in the resources sector is expanding rapidly.[20]

2.21 The RBA expects that next year the level of business investment in Australia will reach its highest level, relative to GDP, in at least half a

15 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.
16 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.
17 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
18 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
19 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
20 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

century. Yet another large liquefied natural gas (LNG) project has recently received final investment approval, bringing the total value of LNG projects approved or under construction to around $180 billion.[21]

2.22 Conditions in many other sectors remain subdued, as a result of the exchange rate, weak consumer demand, the fall-off in public investment and limited building construction. The Queensland coal industry has not fully recovered from the floods of early 2011. Retail spending remains relatively weak. Household consumption has increased, with the household saving ratio at the lowest for two decades. Prices declined a little over 2011. Building construction remains relatively weak.[22]

2.23 Private sector wage growth is currently at its medium-term average pace while public sector wage growth slowed during 2011. Apart from the mining industries, there is little evidence of wage inflation. The most recent inflation data met the RBA's expectations, with underlying inflation around ½ per cent in the December quarter. On a year-ended basis, underlying inflation is at 2½ per cent, which is the midpoint of the medium-term target range, with the outcomes over the second half of the year lower than in the first half.[23]

Table 1 RBA Output growth and inflation forecasts

| | | ***Dec 2011*** | ***June 2012*** | ***Dec 2012*** | ***June 2013*** | ***Dec 2013*** | ***June 2014*** |
|---|---|---|---|---|---|---|---|
| **GDP** | | 2¾ | 3½ | 3-3½ | 3-3½ | 3-4 | 3-4 |
| **CPI** | | 3.1 | 1¾ | 3 | 3¼ | 2½ | 2½-3 |
| **Underlying inflation** | | 2½ | 2¼ | 2¾ | 2¾ | 2½ | 2½-3 |
| **CPI inflation excl carbon price** | | 3.1 | 1¾ | 2½ | 2½ | 2½ | 2½ -3 |
| **Underlying inflation excl carbon price)** | | 2½ | 2¼ | 2½ | 2½ | 2½ | 2½-3 |
| ***Year-average*** | | | | | | | |
| | | ***2011*** | ***2011/12*** | ***2012*** | ***2012/13*** | ***2013*** | ***2013/14*** |
| **GDP growth** | | 2 | 3¼ | 3½ | 3-3½ | 3-3½ | 3-4 |

Technical assumptions include A$ at US$1.07, TWI at 78, and Tapis crude oil price at US$125 per barrel.
Sources: ABS; RBA

*Source* *Reserve Bank of Australia, Statement on Monetary Policy, February 2012, p.67.*

21 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
22 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
23 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

2.24 The headline CPI over the year to December 2011 was 3.1 per cent. Once again, the outcome was affected by banana prices, which subtracted around 0.3 percentage points from inflation in the quarter as supply recovered from Cyclone Yasi. The price of tradables excluding food, fuel and tobacco fell by ½ per cent in the quarter, with falls in the prices of cars and major household appliances. Most other tradable items recorded smaller price declines than recently, which may reflect higher world prices. The prices of non-tradables rose steadily by 0.9 per cent in the quarter and by 3¾ per cent over the year. There were above-average increases in the prices of a range of non-tradables including rents, communication, restaurant and takeaway meals and childcare. Inflation in non-tradables has slowed a great deal since 2008, so further moderation may be required for overall inflation to be consistent with the midpoint of the target range once the effect of the appreciation of the exchange rate on tradables prices falls off.[24]

2.25 The Bank's central forecast remains for around trend GDP growth over 2012 and 2013. Demand is expected to overtake output, with a significant share of the growth in investment met through imports. Employment growth should remain subdued in the near term, with a small increase in the unemployment rate forecast over 2012, after which the rate of unemployment rate will begin to fall over the later part of the forecast period.[25]

2.26 The growth in investment in the resources sector should remain very strong. This is expected to have positive spin-offs for other sectors, although the high exchange rate, fiscal consolidation and reduced consumer spending will mean that overall growth outside the resources sector will remain below trend.[26]

2.27 Europe remains a source of uncertainty. Sovereign debt remains a major problem. Should the debt situation grow any worse, Europe would experience a severe recession, with implications for the global economy. With Australia's scope to adjust macroeconomic policy, the flexible exchange rate and strong banking system, Australia is well placed to deal with that eventuality, should it occur. If this risk were realised, Australian growth would be poorer than the current central forecast.[27]

24 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

25 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

26 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

27 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

2.28 The inflation scenario has changed very little since the August hearing. In underlying terms (and excluding the introduction of the price on carbon) inflation should remain at about the midpoint of the target range for most of the following few years, before increasing late in the forecast horizon as the disinflationary effects from the exchange rate appreciation diminish. Headline inflation should fall below underlying inflation in the near term once the earlier spike in fruit prices continues to fall off. From the September quarter 2012, inflation will be stimulated by the introduction of the carbon price, which is expected to add 0.7 percentage point to headline inflation and around ¼ percentage point to underlying inflation over the following year. This scenario assumes both a modest slowing in domestic cost pressures and that the introduction of the price on carbon does not lead to second-round effects through higher margins or wage claims.[28]

2.29 Since the inflation outlook improved late last year, the Board lowered the cash rate by a cumulative 50 basis points at its November and December meetings, after having maintained a mildly restrictive stance of monetary policy through most of 2011. For the most part, these reductions in official interest rates were passed through to borrowers, so that most lending rates are now close to their medium term averages. At its February meeting, the Board decided to hold the cash rate steady at 4.25 per cent, given that the central forecast was for close to trend growth in GDP and inflation being close to target. The current inflation outlook allows for easier monetary policy should demand conditions weaken substantially. The RBA will continue to monitor information on economic and financial conditions and the Board will adjust the cash rate as required to best encourage sustainable growth and low inflation.[29]

## Banking sector

2.30 As part of the discussion about interest rates, the committee noted that there was a lot of criticism of banks and their profits. The committee asked the Governor if the RBA thought that banks were either over-profitable, simply passing on genuine costs or possibly reacting cautiously. The Governor stated:

28 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 4.

29 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 4.

> ...if I had to choose between unprofitable ones and profitable ones, I would choose the latter...we do not want banks that cannot earn a good return.[30]

2.31 The Governor further elaborated by pointing out that profitability was a relative term, meaningful only in connection with a particular benchmark. The Governor explained that in terms of the rate of return on equity over the last twenty years, bank profits had been broadly in line with the listed company sector in general in Australia. Using that comparator, bank profits were not excessive, though there are other comparators that one could use.[31]

2.32 The committee speculated that if Australian banks were indeed over-profitable then foreign banks would be attracted here so as to take advantage of local conditions and asked the Governor if there was any evidence of this actually happening. The Governor replied that it 'is a reasonable assertion that, if it is really, really profitable here, other players will want to find some way of getting their hands on some of that profit'.[32] The Governor also advised that foreign competition within the domestic banking sector was synchronised with the credit cycle and the cycle of confidence. When global conditions are easy enough, foreign banks increase their Australian presence. When the cycle turns, the foreign banks withdraw to a degree.

2.33 The committee sought the Governor's opinion of the reaction by the banks to the most recent decision of the RBA board concerning the cash rate, when the banks increased interest rates on the grounds of increased funding costs, despite announcing record half-yearly profits. The Governor responded by noting that large institutions can be expected to make large profits and that there is nearly $200 billion of shareholders' money in the banking sector as a whole, of which $160-odd billion would be invested in the four large banks. The Governor teased out the issue by restating the question as 'what is the rate of return being earned by those shareholders on that $160 billion?' The Governor answered himself by noting that over the last twenty years the returns on earning are on average comparable to the returns available on the share market in general.[33]

30 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

2.34 Following a passing reference by the committee to the banks following the cash rate, the Governor explained that 'the period in which the banks followed the cash rate exactly was a rather unusual one historically...If you go way back, there was not such a lock-step pattern at all.'[34] According to the Governor the long term pattern is for credit spreads to shift and that since the crisis in Europe and the US began in 2007 they have, in fact, shifted substantially.

2.35 The Governor also explained that while the cash rate remains a powerful determinant on what banks charge, it is only one of a number of factors involved. Consequently, we should expect to see bank rates move independently of RBA decisions. This is not surprising, given the overall context.[35]

## Cash rate

2.36 The committee was interested in teasing out the technical details of the relationship between the cash rate and market rates, in particular the extent to which this relationship was influenced by either cost increases involved in accessing capital markets. The Governor answered:

> What is the difference between those two things? The same level of profit means that if your costs increase then you want to recover that in the price of your product—any business does. I do not think there is any question that, relative to the cash rate, the costs of some term funding in wholesale markets has risen....So I think when people say those costs have risen that is true. I am not here to defend the banks; they can defend themselves. But most businesses seek to reflect their costs in the prices of their products, if they can, and that industry is no different in that respect.[36]

2.37 The committee wished to pursue the issue of bank costs further and asked the Governor if he thought that Australian banks paid a fair price for funds from the global credit market. The RBA affirmed that Australian banks, given their credit rating, paid the right price. The RBA further explained that while there were Australian corporate institutions that might be able to borrow at cheaper rates overseas than Australian banks

34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 8.

could, Australian banks held their own when compared to overseas banks with comparable credit ratings.[37]

2.38 The committee was interested in the structure of the banking sector and the relationship this might have with interest rates, asking the Governor if Australians might gain cheaper access to credit if the market share of the big four were taken by more banks. The Governor responded by saying that he did not think they would and that 'it is not obvious to me that the market share of those four particularly raises the cost of funding for the overall system'.[38] Moreover, the Governor observed that in most countries there were only a handful of banks. The United States was unusual in being an exception to that rule.

2.39 The committee noted that one of the strengths of the US system is its venture capital market and asked the Governor directly if he thought that the difficulty of accessing credit for risky enterprises was an impediment to productivity growth in Australia. The Governor responded by saying that he was not sure and was unable to estimate how large the venture capital market was in Australia. The RBA advised the committee that the Australian venture capital market has been small and that attempts to enlarge this over the last generation or so have failed. The RBA commented that, 'no-one has ever really been able to come up with a coherent explanation as to why that is the case.' [39] The Governor also made the point that while Australia does not have a market for corporate debt like that of America, very few countries do.

## Bank guarantee

2.40 The committee examined the RBA on the government's bank guarantee. The Governor explained that the government guarantees bank deposits by way of what it calls the financial claims scheme and that the cap on this guarantee was reduced from $1 million to $250,000 a couple of weeks before the current hearing.[40]

2.41 In the event of a bank failure, depositors would get their money very quickly up to the capped amount ($250,000) which would cover almost everyone. Were an institution put into administration by the Australian

37 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 8.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 14.

39 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 14.

40 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 18-19.

Prudential Regulation Authority, the financial claims scheme would come into effect. The institution's assets would be recovered to reimburse creditors, but the scheme would assure depositors of up to $250,000. Monies paid out to individuals under the guarantee would be recovered from funds from the wind-up of the bank. In the Governor's opinion, 'it is extremely unlikely that the scheme would fail to be repaid in that process'.[41]

## Structural adjustment

2.42 The committee noted concerns about differential impact of monetary policy on different sectors of the economy and different regions of Australia. The Governor explained that while there were indeed differential impacts, these had been relatively muted by historical standards, most probably by the fact that the economy was more flexible than it had been in the past. The Governor warned that we need to take care not to overstate things. He also pointed out that monetary policy was a national policy that relied on a single instrument, a single currency.[42]

2.43 The Governor then proceeded to put the situation in the wider, global context:

> What has happened is that there has been a major shift in relative prices, so the prices for natural resources and energy are way up; the prices for manufactured products and some services are down. There is nothing anyone in Australia has done to make that occur; it is a global phenomenon and there is actually nothing we can do to make it go away. It is a feature of the global economy that has occurred. In aggregate, for our country it is an enriching thing because we have such a large natural endowment of natural resources and energy, but also, because it is a relative price shift, that will occasion pressure to change the structure of the economy. There are no two ways about that. Monetary policy cannot make it go away. I do not actually think any policy can make it go away.[43]

2.44 The Governor also advised that to assist with economic adjustment other policy areas would have to be considered, as monetary policy simply cannot do anything about relative prices. He insisted that every other

41 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 19.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

43 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

country in the world has to adjust to this shift in prices. While the adjustment process is not easy, it can be a positive opportunity because of Australia's endowment of natural resources.[44]

2.45 The committee referred to ongoing debate about the pros and cons of currency intervention, citing the example of Switzerland, and asked the Governor if such intervention was a good idea.

2.46 The Governor responded by explaining the details of Switzerland's circumstance, pointing out that Switzerland is experiencing a deflation in consumer prices and that the exchange rate forces at work there were stronger than those which Australia must deal with. The Governor stated frankly that the bank had not attempted any comparable intervention to hold down the value of the Australian dollar because he was not confident that such a move would be effective. The Governor did not rule out such intervention on principle, but once again insisted that we have to see how things develop.[45]

2.47 The committee asked the Governor to comment on sectoral performance. The Governor advised that tourism in some regions, especially Queensland, were suffering, though Sydney hotels appeared to be quite strong. He further elaborated by noting the difficulties of trade-exposed manufacturing and some areas of the construction industry as being weak.[46]

## Investment boom

2.48 The committee asked the Governor to outline the key factors that have an impact on business investment and, in particular, the issue of business uncertainty. The Governor responded by saying that the biggest single factor would have to be the shift in relative prices. The Governor noted that the share of business investment to GDP was now as high as it has ever been in the last fifty years. This situation has been brought about by the high price of the natural resources that Australia has so much of – iron ore, coal and gas. The Governor noted that with respect to the rest of the economy, which was not involved with resource extraction, the level of

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

45 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

46 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 7-8.

business investment was not high, neither was it problematically low. It was all simply a part of the adjustment to the shift in relative prices.[47]

2.49 A brief discussion of the implications of uncertainty ensued, with the committee referring to an article published on the date of the hearing, in which Dom Argus called for greater certainty for business.[48] This article came in the wake of similar calls by business leaders and the committee sought the Governor's input on this issue. The Governor stated:

> ...if it were true that there was a serious perception of elevated sovereign risk for Australia, I do not think we would be seeing the appetite for Australian dollar denominated Australian government debt that we have seen, which has been quite strong lately. At least that factor leads me to be wary of drawing strong conclusions about sovereign risk. There are other elements where there can be uncertainty, over regulation and so on, and that maybe what business people are referring to. I am not really convinced that sovereign risk is a major issue at least at present.[49]

## Productivity

2.50 The committee explored the issue of productivity, with a member referring to an unspecified recent comment by the Business Council of Australia that Australia was becoming a high-cost low-productivity country. The Governor stated:

> I think the facts on productivity are that, pretty much whichever way you cut it, we had a period of quite good growth in productivity in the decade up to sometime in the early 2000s—maybe around 2002 or 2003—and since then, at least as I eyeball the figures, the trend rate of growth of productivity has slowed materially... There is no question that rising productivity is really fundamentally the only source of higher living standards available to a community, particularly one that starts with reasonably full employment overall, as we do. From here, rising output from our

47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5-6.

48 "Lucky country 'at risk' amid chaos, says Don Argus", Annabel Hepworth and Scott Murdoch, *The Australian*, 24 February 2012. The article is available electronically at: http://www.theaustralian.com.au/national-affairs/lucky-country-at-risk-amid-chaos-says-don-argus/story-fn59niix-1226280006022

49 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 6.

> capital stock and our workforce is really the only source of higher standards of living.[50]

2.51 In the course of examining productivity, the committee sought the Governor's views on whether the level of industrial disputation is considered by the RBA and flowing through to its decisions. The Governor stated that he could not recall industrial relations per se ever being raised in a serious way when setting the cash rate. However, he acknowledged that the bank did take careful note of the effect of wage growth on costs, stating that the bank monitored aggregate data on this. The Governor also explained that wage growth might make it harder to reach the inflation target, but so far this was not the case. The Governor made the caveat that if the rate of wages growth were to accelerate materially from recent levels, he would be concerned.[51]

2.52 The Governor advised the committee that though improving productivity was far from easy, he did expect an improvement in productivity in the foreseeable future. In the Governor's words:

> I think it is a reasonable forecast to make, that there will be some improvement. I do not have in my head the extent of the pick-up that we are contemplating. But the reason I think that that is likely is that we are, as we have been saying earlier, in a period of structural change. I think it has probably accelerated in recent times. It would normally be expected that that results in an acceleration in productivity improvement. It is not an easy process for the firms doing it. Sometimes when we talk about productivity I think there is a tendency in community discussions to think of this as a very nice, soft, wonderful concept and that we can just dial it up, but it actually does not work that way; it works by firms, managements and workforces grinding out difficult changes to the way they do things every day. [52]

2.53 The Governor also insisted that productivity needed to be understood within the wider context of wage growth and other costs and that overall productivity was not simply a matter of labour productivity, but of capital productivity as well.[53]

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 6.

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 7.

52 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

53 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

## Labour market

2.54 The unemployment rate is about 5¼ per cent. Employment growth has slowed, while employment has declined in several industries including manufacturing, retail and real estate, but increased in others such as mining. The increased demand for labour was mostly met by existing employees working longer hours. The forward-looking indicators suggest moderate growth in employment ahead, although the RBA's liaison suggests that some firms seek greater certainty in their environment before hiring additional workers.[54] During the hearing, the RBA was asked what might happen to unemployment over the coming year. The RBA advised that unemployment will rise then start to decline. The RBA stated:

> In our central forecast we have the unemployment rate drifting up probably to around 5½ per cent some time over the course of the next year and then gradually coming down a little bit. What we detect at the moment when we talk to business is some reticence about hiring. In 2010 businesses were prepared to hire on the prospect of stronger demand. Now they want to actually see the stronger demand before they commit to taking on extra workers. That is attributing to the softness in the labour market. Over time, if our view about the demand strength in the economy turns out to be true, I think businesses will feel that they have the confidence to actually go and hire workers a bit more aggressively again than they have over the past year and so the unemployment rate will then drift down a bit. But most of the time over the next two years I think we will be sitting with the unemployment rate between five per cent and 5½ per cent.[55]

2.55 The committee asked the RBA whether it was concerns by the business community that flexibility of the labour market was impacting on their decision to hire new workers. In response to this, the RBA stated:

> I do not think that is the major issue here. I think it is global uncertainty. It was not that long ago that we had the IMF talking about the possibility of another 1930s moment. That is typically not an environment in which businesses feel emboldened to go and hire workers on the prospect of stronger demand. There are obviously a whole range of other factors at play here, but I think the first order one is really the global environment. If that can

54 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

55 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript*, 24 February 2012, p. 9.

> settle down and private demand in Australia grows like we think it will, I think we will see the employment growth come back again.[56]

## Global uncertainty

2.56 The committee discussed the prospect of further difficulties in Europe and what impact this might have for the Australian economy. The Governor referred to Greece and the assistance package now in place. He explained that what needed to be done was pretty clear, but nonetheless difficult, on account of the fiscal problems at work.[57] He acknowledged the risk that reform might impede growth. The Governor also explained that a key issue was the need for European banks to develop stronger capital positions and that this need to be accomplished by attracting capital rather than by deleveraging. Most importantly of all, the Governor insisted that there needed to be supply-side growth and positive reforms. The Governor stated:

> ...you have 27 countries in the EU all trying to do this in some kind of reasonably coordinated fashion. This is no easy project, but that is what they are attempting and we all have an interest in them managing to pull it off...I think some credit should be given for some progress having been achieved recently. There is a long way to go, and during that time we will periodically at these hearings still be talking about what happens in Europe. I think we will be talking about that for a few years, really.[58]

2.57 The committee sought the Governor's views on how he thought the situation in Europe was likely to develop over the next six to twelve months, focusing on inflation/deflation issues. The Governor responded by stating that Europe was in a down-turn, which, at an aggregate level, would probably be a deep one. The attempted recuperation of the Greek economy, and those of several other peripheral economies, would continue, albeit with 'flare-ups every few months'.[59]

56 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript*, 24 February 2012, p. 9.

57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

58 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 11.

59 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 20.

2.58 Regarding inflation versus deflation, the Governor characterised the question as being if the unusual central bank action would ultimately be deflationary. The Governor said that the situation was complex:

> I think it will be a tricky balance to manage, with very high levels of public debt, unusually low interest rates for a long period and bloated balance sheets. It will be a long, tricky way back to normal from there. In that sense, it is not that surprising that some people worry about the potential for longer run inflation. I think one can understand why the central banks will need to manage this process very carefully.[60]

2.59 The RBA noted that the real surprise was the failure of inflation rates to fall even more in the United States and in Europe. In the US unemployment has been at 10 per cent for a while and it is now a bit above eight per cent, while in Europe it is above 10 per cent. Yet inflation is between one and two per cent. Just why this is so is not entirely clear but developments in commodity prices, which have trended up in recent years, have played a part. Consequently, the RBA noted that, 'in the short term the risks are probably on the downside of inflation but in the medium term on the upside'.[61]

## Inflation

2.60 The committee noted the strength of inflation in non-tradables when Australian growth since 2008 has been below average and households have begun to increase their rate of saving. The Governor explained that there had been a number of steep rises in utility prices, which he did not expect to get even steeper on a percentage change basis over time. The bank forecasts that over time this will slow down, assuming that there is some improvement in productivity growth over the period. In the Governor's view, that is a reasonable assumption.[62]

2.61 The committee, referring to  work on the RBA's perceived priorities published by a pair of academic economists in 2012, sought the Governor's advice on the bank's dual mandate (to target inflation and output simultaneously), in particular if the bank had some kind of formula

60 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 21.

61 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 21.

62 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

for weighing the relative importance of its competing priorities.[63] The Governor stated that he did not have any precise weighting in mind when deliberating on interest rates. The Governor explained that the inflation targeting policy of the bank allowed them to address both priorities simultaneously in a way that worked well. The RBA explained that this sort of analysis was not necessarily all that meaningful, as it was simply not possible to map the variability of inflation and output with precision.[64]

2.62 The Governor characterised the bank's position on the dual mandate by stating:

> ...we are not what Mervyn King used to call 'inflation nutters' to the extent that we give no regard to the real economy at all, but nor are we so intent on trying to finetune real economic activity that we let the medium-term path of inflation drift seriously off course. So we should not be in either of those extreme positions, and we are not. I do not know whether one-third, two-thirds is the correct assessment of what we are doing. I think there is some substance to saying we are not in either of the corner solutions, and I think it is appropriate that we not be.[65]

2.63 The Governor explained that the current inflation targeting framework had been in place for about twenty years and was working well, with successful results for inflation and output.[66]

2.64 The committee noted that during the last mineral boom the unemployment rate was closer to four per cent, albeit with inflation outside the target band, and asked the Governor if it was reasonable to estimate that the minimum sustainable level of unemployment is now closer to five per cent? The Governor stated:

> I am not doctrinaire on unemployment rates, because there are various reasons they can shift...I do not quite feel comfortable with the notion that there is a hard barrier for unemployment—that it is a particular number and you must not go below or above that. I

63 Mr Glenn Stevens, Governor of the RBA, Transcript, 24 February 2012, p. 11. The work in question was a paper by Glenn Otto and Graham Voss, 'What do the RBA's Forecasts Imply about its Preferences over Inflation and Output Volatility?', *The Economic Record*, vol. 87, No 279, December, 2011 pp. 509-524; the article is available electronically at: http://onlinelibrary.wiley.com/doi/10.1111/j.1475-4932.2011.00763.x/pdf

64 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 11.

65 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.

66 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.

> think we should be a little bit reluctant to be too doctrinaire about numbers.[67]

# Governance

## Securency and Note Printing Australia

2.65 At the previous public hearing on 26 August 2011, the committee sought advice from the RBA on the timeline and actions taken in regard to the bribery allegations surrounding Securency and Note Printing Australia. The committee returned to this subject, seeking details from the bank on developments since the last hearing.

2.66 The Governor advised the committee that a number of criminal charges had been laid against individuals and the companies involved.

2.67 When asked by the committee if, with the benefit of hindsight, the bank would have done things differently, the Governor answered:

> That is a question I ask myself. With these things still all unfolding, it is possibly not the right moment today in a public forum to give a considered and final answer to that...I think that since the allegations about Securency emerged in 2009 the way the bank has responded to that has been correct and the way the company has responded has been correct.[68]

2.68 In May or June 2009 the Governor briefed both the Treasurer and the then Prime Minister orally on the allegations regarding Securency and Note Printing Australia. In June 2010 the Governor on his own initiative wrote a letter to the Treasurer outlining the details of the case.[69]

2.69 The Governor also clarified the role that an individual staff member of Note Printing Australia played in relaying intelligence about developments with the case. After receiving an oral briefing on these developments, the then Deputy Governor requested that the staff member make a 'written statement on the matter which was available to the Freehills people that did the investigation in 2007.'[70]

67 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.
68 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 16.
69 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 17.
70 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 23-24.

## Conclusion

2.70 Australia continues to enjoy near-ideal conditions by international standards. The fundamentals of the Australian economy are strong. Public debt and unemployment are low, underlying inflation is at the midpoint of the inflation target range, and we have a significant pipeline of business investment, particularly in the resources sector.

2.71 While banking profits and market interest rates continue to provoke comment, the banking sector as a whole appears resilient and robust. As such, it provides the Australian people with a degree of assurance in a time of heightened global uncertainty.

2.72 Over the medium-term monetary policy is expected to meet the goals of its long-standing inflation target, with inflation remaining within the 2 to 3 per cent band.

**Julie Owens MP**
**Chair**
**14 March 2012**

A

# Appendix A — Hearing, witnesses and briefing

## Public hearing

### Friday, 24 February 2012 – Sydney

*Reserve Bank of Australia*

Mr Glenn Stevens, Governor
Dr Philip Lowe, Deputy Governor
Dr Guy Debelle, Assistant Governor (Financial Markets)

## Private briefing

### Wednesday, 15 February 2012 – Canberra

Ms Su-Lin Ong, Managing Director, Head of AU/NZ Economics & Fixed Income Strategy, RBC Capital Markets

B

# Appendix B — *Statement on the conduct of monetary policy*

**The Treasurer and the Governor of the Reserve Bank**

**30 September 2010**

This statement records 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 the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework. Since 1996, this framework has been formalised in a Statement on the Conduct of Monetary Policy. The inflation targeting framework has served Australia well and is reaffirmed in the current statement.

This statement should continue to foster a better understanding, both in Australia and overseas, 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.

This statement also records our common understanding of the Reserve Bank's longstanding responsibility for financial system stability.

## Relationship between the Reserve Bank and the Government

The *Reserve Bank Act 1959* (the Act) gives the Reserve Bank Board the power to determine the Reserve Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Reserve Bank Board.

The Government recognises the independence of the Reserve Bank and its responsibility for monetary policy matters and will continue to respect the Reserve Bank's independence as provided by statute.

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 removes the potential for political considerations in the appointment process and ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Reserve Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Reserve Bank's responsibility for monetary policy, the Act provides that the Reserve Bank Board shall, from time to time, inform the Government of the Reserve Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole, the Government reserves the right to comment on monetary policy from time to time.

## 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.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed of economic policy as a whole. These objectives allow the Reserve Bank Board to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Reserve Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of jobs, protect the savings of Australians and preserve 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.

Since the adoption of inflation targeting in the early 1990s, inflation has averaged around the midpoint of the inflation target band. The Governor takes this opportunity to express his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates that it endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

## Transparency and Accountability

Monetary policy needs to be conducted in an open and forward-looking way. A forward-looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Reserve Bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. The Governor issues a statement immediately after each meeting of the Board, announcing and explaining the Board's monetary policy decision, and minutes of each meeting are issued two weeks later providing background to the Board's deliberations. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its quarterly *Statement on Monetary Policy* and *Bulletin*, have been crucial in promoting increased understanding of the conduct of monetary policy. The Reserve Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of making himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics.

The Treasurer expresses support for the continuation of these arrangements, through which the transparency and accountability of the Reserve Bank's conduct of monetary policy are in line with international best practice. These arrangements enhance the public's confidence in the independence and integrity of the monetary policy process.

## Financial Stability

The stability of the financial system is critical to a stable macroeconomic environment. Financial stability is a longstanding responsibility of the Reserve Bank and its Board, and was reconfirmed at the time of significant changes made to Australia's financial regulatory structure in July 1998. These changes included the transfer of responsibility for the supervision of banks to a new integrated regulator, the Australian Prudential Regulation Authority (APRA), and the establishment of the Payments System Board within the Reserve Bank.

The Reserve Bank Board oversees the Bank's work on financial system stability. Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system. It does this in several ways, including through its central position in the financial system and its role in managing and providing liquidity to the system, and through its chairmanship of the Council of Financial Regulators, comprising the Reserve Bank, APRA, the Australian Securities and Investments Commission and Treasury. In addition, 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* and will be available to report as appropriate to relevant Parliamentary committees.

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 co-ordinate closely with the Government and with the other Council agencies.

The Treasurer expresses support for these arrangements, which served Australia well during the recent international crisis period.

C

# Appendix C — Glossary of terms

***Australian Competition and Consumer Commission (ACCC).*** A Commonwealth statutory authority responsible for ensuring compliance with the *Trade Practices Act 1974* and the provisions of the Conduct Code and for administering the *Prices Surveillance Act 1983*. The Commission's consumer protection work complements that of State and Territory consumer affairs agencies.

***Australian Payments Clearing Association Limited (APCA).*** A public company owned by banks, building societies and credit unions which has specific accountability for key parts of the Australian payments system, particularly payments clearing operations.

***Australian Prudential Regulation Authority (APRA).*** APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

***Australian Securities and Investments Commission (ASIC).*** One of three Australian Government bodies (the others being the Australian Prudential Regulation Authority and the Reserve Bank of Australia) that regulates financial services. ASIC is the national regulator of Australia's companies. ASIC has responsibility for market protection and consumer integrity issues across the financial system.

***accrual accounting.*** Revenues and expenses are recorded as they are earned or incurred, regardless of whether cash has been received or disbursed. For example, sales on credit would be recognised as revenue, even though the debt may not be settled for some time.

***acquirer.*** An institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers.

***average weekly earnings.*** Average gross (before tax) earnings of employees.

***average weekly ordinary time earnings (AWOTE).*** Weekly earnings attributed to award, standard or agreed hours of work.

***average weekly total earnings.*** Weekly ordinary time earnings plus weekly overtime earnings.

***balance on current account.*** The difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

***bankruptcies.*** Bankruptcies and Administration Orders under Parts IV and XI of the Bankruptcy Act.

***basis point.*** A basis point is 1/100th of 1 percent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

***BPAY.*** BPAY is a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

***business investment.*** Private gross fixed capital formation for machinery and equipment; non-dwelling construction; livestock; and intangible fixed assets.

***card issuer.*** An institution that provides its customers with debit or credit cards.

***cash rate (interbank overnight).*** Broadly defined, the term cash rate is used to denote the interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis. The Reserve Bank of Australia uses a narrower definition of the cash rate as an operational target for the implementation of monetary policy. The Reserve Bank of Australia's measure of the cash rate is the interest rate which banks pay or charge to borrow funds from or lend funds to other banks on an overnight unsecured basis. This measure is also known as the interbank overnight rate. The Reserve Bank of Australia calculates and publishes this cash rate each day on the basis of data collected directly from banks. This measure of the cash rate has been published by the Reserve Bank of Australia since June 1998.

***cash rate target.*** As in most developed countries, the stance of monetary policy in Australia is expressed in terms of a target for an overnight interest rate. The rate used by the Reserve Bank of Australia is the cash rate (also known as the interbank overnight rate). When the Reserve Bank Board decides that a change in monetary policy should occur, it specifies a new target for the cash rate. A decision to ease policy is reflected in a new lower target for the cash rate, while a decision to tighten policy is reflected in a higher target.

***charge card.*** A charge card is a card whose holder has been granted a non-revolving credit line enabling the holder to make purchases and possibly make cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.

***consumer price index.*** A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

***collateralised debt obligations.*** Collateralised debt obligations (CDOs) are securities that are exposed to the credit risk of a number of corporate borrowers. In the simplest form of a CDO, this credit risk exposure is generated in the same way as for any asset-backed security (ABS): the CDO is backed by outright holdings of corporate debt, such as corporate bonds and corporate loans. Increasingly, however, the exposure to corporate credit risk is synthesised through the use of credit derivatives. Unlike other forms of ABS, where the collateral pools usually consist of loans with broadly similar characteristics, CDO reference pools are typically quite heterogeneous, with exposures to a variety of borrower types and credit ratings and across a number of countries. A CDO will usually have exposures to between 50 and 200 bonds or large corporate loans, or up to 2,000 loans to small and medium-sized businesses.

The simplest forms of CDOs are known as ‘cash' or ‘vanilla' CDOs, and are similar to other forms of ABS. A special purpose vehicle buys loans and securities from financial institutions and other market participants, and funds these acquisitions by selling securities to investors. The manager of the CDO vehicle will usually deduct fees and expenses from the interest income received from the assets in the collateral pool, with the remainder used to make regular coupon payments to investors. The term to maturity of the loans and bonds in the collateral pool will determine the maturity of the CDO securities sold to investors.

***credit card.*** A credit card is a card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period or in part, with the balance taken as extended credit. Interest may be charged on the transaction amounts from the date of each transaction or only on the extended credit where the credit granted has not been settled in full.

***debit card.*** A debit card is a card that enables the holder to access funds in a deposit account at an authorised deposit-taking institution.

***derivative.*** A financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options.

***employed persons.*** Persons aged 15 and over who, during a period of one week, worked for one hour or more for pay or worked for one hour or more without pay in a family business or on a family farm.

***G-10.*** Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and USA; plus Bank for International Settlements (BIS), European Commission, International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development (OECD). It was formed in conjunction with the establishment of the General Arrangements to Borrow, under which members agreed to make resources available to the IMF.

***G-20.*** Group of Twenty Forum: Members are finance ministers or central bankers from - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK and US; plus representatives of the IMF, European Union and World Bank. The G-20 aims to broaden the dialogue on key economic and financial policy issues among systemically significant economies, and promote co-operation to achieve stable and sustainable world economic growth.

***G-22.*** Group of Twenty-two. The G-22's aim was to advance issues related to the global financial architecture. It operated through three Working Parties - on Transparency and Accountability, International Financial Crises, and Strengthening Financial Systems. The group made its recommendations in 1998, and its work has since been taken up in other forums.

***G-7.*** Group of Seven countries: Canada, France, Germany, Italy, Japan, UK and USA. The G-7 Summit deals with issues covering macroeconomic management, international trade, international financial architecture, relations with developing countries, and other global issues.

***G-8.*** Group of Eight countries: G-7 countries and Russia.

***gross domestic product.*** The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production but before deducting for depreciation.

***gross domestic product—chain volume measure.*** Also known as *real GDP*, this is a measure used to indicate change in the actual quantity of goods and services produced. Economic growth is defined as a situation in which real GDP is rising.

***gross domestic product at factor cost.*** Gross domestic product less the excess of indirect taxes over subsidies.

***gross foreign debt.*** All non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia.

***household debt ratio.*** The amount of household debt at the end of a quarter expressed as a proportion of annual household gross disposable income.

***household gross disposable income.*** The amount of income that households have available for spending after deducting any taxes paid, interest payments and transfers overseas.

***household net disposable income.*** Household gross disposable income less depreciation of household capital assets.

***household saving ratio.*** The ratio of household income saved to household net disposable income.

***housing loan interest rate.*** The variable rate quoted by banks for loans to owner-occupiers.

***implicit price deflator for non-farm gross domestic product.*** A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.

***index of commodity prices.*** A Reserve Bank of Australia-compiled index (based 2001/02=100) which provides a measure of price movements in rural and non-rural (including base metals) commodities in Australian Dollars (AUD), Special Drawing Rights (SDR) and United States Dollars (USD).

***inflation.*** A measure of the change (increase) in the general level of prices.

***inflation target.*** A tool to guide monetary policy expressed as a preferred range or figure for the rate of increase in prices over a period. In Australia, the inflation target is between 2 and 3 per cent per annum on average over the course of the business cycle.

***interchange fee.*** A fee paid between card issuers and acquirers when cardholders make transactions.

***interest rate.*** The term used to describe the cost of borrowing money or the return to the owner of the funds which are invested or lent out. It is usually expressed as a percent per annum of the amount of money borrowed, lent or invested.

***labour force.*** The employed plus the unemployed.

***labour force participation rate.*** The number of persons in the labour force expressed as a percentage of the civilian population aged 15 years and over.

***labour productivity.*** Gross domestic product (chain volume measure) per hour worked in the market sector.

***long-term unemployed.*** Persons unemployed for a period of 52 weeks or more.

***macroeconomy.*** The economy looked at as a whole or in terms of major components measured by aggregates such as gross domestic product, the balance of payments and related links, in the context of the national economy. This contrasts with microeconomics which focuses upon specific firms or industries.

***market sector.*** Five industries are excluded from the market sector because their outputs are not marketed. These industries are: property and business services; government administration and defence; education; health and community services; and personal and other services.

***monetary policy.*** The setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

***natural increase.*** Excess of live births over deaths.

***net foreign debt.*** Gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

***net overseas migration.*** Net permanent and long-term overseas migration plus an adjustment for the net effect of 'category jumping'.

***non-farm gross domestic product.*** Gross domestic product less that part which derives from agricultural production and services to agriculture.

***overseas visitors.*** Visitors from overseas who intend to stay in Australia for less than 12 months.

***prime interest rate.*** The average rate charged by the banks to large businesses for term and overdraft facilities.

***profits share*.** Gross operating surplus (the excess of gross output over costs incurred in producing that output) of all financial and non-financial corporate trading enterprises as a percentage of gross domestic product at factor cost.

***real average weekly earnings.*** Average weekly earnings adjusted for inflation as measured by the Consumer Price Index.

***real prime interest rate.*** The prime interest rate discounted for inflation as measured by the Consumer Price Index.

***seasonally adjusted estimates.*** Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

***terms of trade.*** The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is to divide the implicit price deflator for exports by the implicit price deflator for imports.

***trade weighted index.*** A measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners.

***turnover.*** Includes retail sales; wholesale sales; takings from repairs, meals and hiring of goods; commissions from agency activity; and net takings from gaming machines. From July 2000, turnover includes the Goods and Services Tax.

***unemployed persons.*** Persons aged 15 and over who, during a period of one week, were not employed but had actively looked for work in the previous four weeks and were available to start work.

***unemployment rate.*** The number of unemployed persons expressed as a percentage of the labour force.

***wage price index.*** A measure of change in the price of labour (i.e. wages, salaries and overtime) unaffected by changes in the quality or quantity of work performed.

***wages share.*** Wages, salaries and supplements (the total value of income from labour) as a percentage of gross domestic product at factor cost.

***west texas intermediate.*** A type of crude oil used as a benchmark in oil pricing and the underlying commodity of New York Mercantile Exchange's oil futures contracts.

***youth unemployment.*** Number of 15–19 year olds looking for full-time work.

***youth unemployment rate.*** Number of 15–19 year olds looking for full-time work expressed as a percentage of the full-time labour force in the same age group.

*Source: Parliamentary Library and Reserve Bank of Australia*