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Review of the Reserve Bank of Australia Annual Report 2013 (Third Report)

House of Representatives
Standing Committee on Economics

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Chair’s foreword

The RBA has recently forecast Australia's trading partner growth to be a little above its long-run average, assisted by strong export trade to China. It is encouraging that expectations of stronger growth in the advanced economies are strengthening.

At the August hearing before the committee, the Governor of the Reserve Bank estimated Australian growth at two to three per cent of GDP over the year ahead. He commented that our near-term growth may be slightly below recent trends but could increase to above trend in the future.

The RBA continues to hold official interest rates at two and a half per cent, due in part to favourable financial conditions and adequate capital inflows to market economies. The Governor has commented that lowering cash rates was unlikely to encourage growth in the current environment, although it could be considered under appropriate circumstances. The committee has learned that there is currently very low volatility in financial prices. The Governor has also commented previously that markets are not anticipating global interest rate rises or other adverse events in the period ahead.

The exchange rate continues to remain high by historical standards and the Australian dollar has seen little recent change on a trade-weighted basis and against the US dollar. The Governor commented that Australia has undergone a re-rating over the past five to ten years from the global capital markets perspective and this has contributed significantly to the high Australian dollar.

The unemployment rate has increased slightly in recent months and the Governor has commented that reversing this trend may take some time despite improvements in labour market indicators. The Governor has stated that the labour market is responding to these conditions with slower growth in wages, and there are indications of a lower unemployment rate into the future which is to be welcomed.

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 20 August 2014.

Kelly O'Dwyer MP
Chair

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Membership of the Committee

Chair	Ms Kelly O'Dwyer MP
Deputy Chair	The Hon Ed Husic MP
Members	Mr Scott Buchholz MP
	Dr Jim Chalmers MP
	Mr David Coleman MP
	Mr Pat Conroy MP
	Dr Peter Hendy MP
	Mr Kevin Hogan MP
	Mr Craig Kelly MP
	Mr Clive Palmer MP
Supplementary Members	The Hon Tony Smith MP
	The Hon Dr Andrew Leigh MP

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Secretary	Mr Peter Banson
Inquiry Secretary	Dr Kilian Perrem
Research Officers	Mrs Jacqueline Mayer
	Ms Marina Katic
Administrative Officers	Ms Jazmine Rakic
	Ms Sarah Tutt

Terms of reference

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.

1

Introduction

Background

1.1 The House of Representatives Standing Committee on Economics (the committee) is responsible for scrutinising the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the community and the financial sector.

1.2 The appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Joe Hockey MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix B, states:

> … the Governor will continue to be available to report twice a year to the House of Representatives Standing Committee on Economics, and to other Parliamentary committees as appropriate.
>
> The Treasurer expresses support for the continuation of these arrangements, which reflect international best practice and enhance the public's confidence in the independence and integrity of the monetary policy process.[1]

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual report of the RBA.

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

Scope and conduct of the review

1.4 The third public hearing of the committee with the RBA during the 44th Parliament was held in Brisbane on 20 August 2014.

1.5 The proceedings of the hearing were webcast over the internet, through the Parliament's website, allowing interested parties to listen to the proceedings as they occurred. The transcript of the hearing is available on the committee's website.[2]

1.6 Before the hearing, the committee received a private briefing from Mr Stephen Walters, Chief Economist, JP Morgan. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Walter's cooperation and assistance.

1.7 Public hearings with the RBA continue to bring issues of monetary policy into the public arena and provide a public face to parliamentary committees and the RBA. These hearings are also an important means by which financial markets can be better informed on the current thinking of the RBA.

1.8 This report focuses on matters raised at the public hearing in Brisbane on 20 August, and also draws on issues raised in the RBA's August 2014 *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA website.[3]

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2 House of Representatives Standing Committee on Economics, Past Public Hearings and Transcripts, <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBA_2013_Annual_Report/Public_Hearings > viewed 4 September 2014.

3 Reserve Bank of Australia, 'Statement on Monetary Policy', <http://www.rba.gov.au/publications/smp/index.html> viewed 4 September 2014.

2

Monetary policy and other issues

Overview

2.1 On 5 August 2014 the Reserve Bank of Australia (RBA) decided to hold official interest rates at two and a half per cent. In his statement on the decision, the Governor noted that:

> Financial conditions overall remain very accommodative. Long-term interest rates and risk spreads remain very low. Emerging market economies are receiving capital inflows. Volatility in many financial prices is currently unusually low. Markets appear to be attaching a very low probability to any rise in global interest rates, or other adverse event, over the period ahead.[1]

2.2 The Governor noted that in general the RBA expected growth to be slightly below trend for the following year.[2] He stated: 'looking ahead, continued accommodative monetary policy should provide support to demand and help growth to strengthen over time'.[3]

2.3 The Governor further commented:

> There has been some improvement in indicators for the labour market this year, but it will probably be some time yet before unemployment declines consistently. Recent data showed an increase in inflation, with both headline and underlying measures affected by the decline in the exchange rate last year. But growth

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1 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see: <http://www.rba.gov.au/media-releases/2014/mr-14-12.html>.

2 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see: <http://www.rba.gov.au/media-releases/2014/mr-14-12.html>.

3 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see: <http://www.rba.gov.au/media-releases/2014/mr-14-12.html>.

> in wages has declined noticeably and is expected to remain relatively modest over the period ahead, which should keep inflation consistent with the target even with lower levels of the exchange rate.[4]

2.4 In relation to the Board's decision, the Governor concluded:

> In the Board's judgement, monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates.[5]

2.5 During the hearing on 20 August 2014, the Governor remarked on the expansion of the global economy since the committee's hearing in March. He noted that it had continued to expand at a moderate pace and Australia's trading partner group had been growing at approximately its long run average rate.[6]

2.6 In relation to the Australian economy, the Governor estimated that growth of real GDP over the year ahead would be around two to three per cent.[7] The Governor stated that this was 'close to trend but probably a bit below trend in the near term. Further ahead, I think, there are reasons to feel that growth can speed up somewhat and be a bit above trend'.[8]

2.7 The Governor recognised that the possibility of real GDP growth being slightly below trend in the near term may be disappointing.[9] He commented that:

> … the thing that is most needed now is something that monetary policy cannot directly cause. What I mean is we need more of the sort of so-called 'animal spirit', or confidence if you like, that is needed to support not just a repricing of the existing stock of assets, but the investment that adds to that stock of physical assets.[10]

2.8 The Governor noted that the role of monetary policy is to support demand and pursue full employment and price stability, taking due account of

4 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see: <http://www.rba.gov.au/media-releases/2014/mr-14-12.html>.

5 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see: <http://www.rba.gov.au/media-releases/2014/mr-14-12.html>.

6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 1.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 2.

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.

financial stability considerations.[11] He added that 'in reaching its decisions the board has been mindful of allowing time for the measures already taken to have their effects and of the very considerable limitations that monetary policy has in fine-tuning outcomes over any short period.'[12]

2.9 Dr Philip Lowe, Deputy Governor of the RBA, also commented on the role of monetary policy, noting that monetary policy is not intended as the main driver of growth in the economy.[13] He stated:

> We can help smooth out the fluctuations, but we cannot in the end drive the overall growth in the economy. It is really structural issues that do that… If we are going to sustain ourselves there, people need to be able to take risk, they need to be able to be rewarded for risk and we need to innovate to find new ways of doing things better. I think it is about somehow enlivening the entrepreneurial, risk-taking and innovation culture so that we can be the type of country that has high value-added, high wages and high productivity.[14]

2.10 During the hearing, the committee questioned the Governor and the other RBA officials who appeared on the current fiscal and monetary policy frameworks and their impacts. The areas of discussion included the cash and exchange rates, inflation, the labour market, economic growth and small business.

Forecasts

2.11 In its August 2014 *Statement on Monetary Policy*, the RBA forecasts Australia's trading partner growth to be a little above its long-run average in 2014 and 2015,[15] stating that:

> The slight strengthening in growth compared with recent years reflects the expectation of stronger growth in the advanced economies as well as the growing share of Australian exports destined for China, an economy that is growing much faster than Australia's other trading partners.[16]

11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.
12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.
13 Dr Philip Lowe, Deputy Governor of the RBA, *Transcript*, 20 August 2014, p. 11.
14 Dr Philip Lowe, Deputy Governor of the RBA, *Transcript*, 20 August 2014, p. 11.
15 RBA, *Statement on Monetary Policy*, August 2014, p. 1.
16 RBA, *Statement on Monetary Policy*, August 2014, p. 1.

2.12 The RBA further comments in this Statement that 'Australian GDP growth picked up to an above average pace over the second half of 2013 and early 2014, with much of this increase accounted for by a surge in resource exports.'[17] The RBA adds:

> Even so, there have been signs of improved economic conditions over the past year outside the resources sector… GDP growth is expected to be a little below average over 2014/15 and then pick up gradually to an above-average pace, with non-mining business investment and liquefied natural gas (LNG) exports forecast to add to growth.[18]

2.13 The RBA Statement highlights the general improvement in forward-looking indicators of labour demand since late last year, suggesting modest employment growth over coming months.[19] The RBA further notes:

> However, there remains a degree of spare capacity in the labour market. The measured unemployment rate has been quite volatile from month to month over the year to date. It is currently around its highest level in over a decade.[20]

2.14 The Statement also explains that low wage growth and domestic costs in general have contributed to containing inflation for a range of goods and services,[21] noting that:

> Over the year to the June quarter, the various measures indicate that underlying inflation was 2¾ per cent, about ½ percentage point higher than a year earlier. In the June quarter, underlying inflation was ¾ per cent, higher than the ½ per cent recorded in March, but similar to the rate in the preceding two quarters.[22]

2.15 The Statement indicates that, generally, domestic inflationary pressures are likely to remain moderate, reflecting the ongoing spare capacity in labour and product markets.[23] The RBA also notes that:

> The recent abolition of the carbon price has changed the forecast for inflation and lowered the profile of the CPI; inflation is now

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17 RBA, *Statement on Monetary Policy*, August 2014, p. 2.
18 RBA, *Statement on Monetary Policy*, August 2014, pp. 2-3.
19 RBA, *Statement on Monetary Policy*, August 2014, p. 3.
20 RBA, *Statement on Monetary Policy*, August 2014, p. 3.
21 RBA, *Statement on Monetary Policy*, August 2014, p. 3.
22 RBA, *Statement on Monetary Policy*, August 2014, p. 3.
23 RBA, *Statement on Monetary Policy*, August 2014, p. 4.

projected to be lower in 2014/15 than previously assumed, but a bit higher in 2015/16 than previously forecast.[24]

Table 1 RBA Output growth and inflation forecasts (per cent)[(a)]

Year-ended							
		June 2014	**Dec 2014**	**June 2015**	**Dec 2015**	**June 2016**	**Dec 2016**
GDP growth		3	2½	2-3	2½–3½	2¾-3¾	2¾ -4¼
Non-farm GDP growth		3¼	2¾	2-3	2½–3½	2¾-3¾	2¾ -4¼
CPI inflation[(b)]		3	2	1¾-2¾	2½–3½	2½–3½	2¼–3¼
Underlying inflation[(b)]		2¾	2¼	1¾-2¾	2¼–3¼	2-3	2-3
Year-average							
		2013/ 2014	**2014**	**2014/ 2015**	**2015**	**2015/ 2016**	**2016**
GDP growth		3	3	2-3	2-3	2½–3½	2¾-3¾

(a) Technical assumptions include A$ at US$0.93, TWI at 72 and Brent crude oil price at US$106 per barrel.

(b) Based on current legislation for the price of carbon

Source Reserve Bank of Australia, Statement on Monetary Policy, August 2014, p. 71.

2.16 At the hearing the Governor discussed trends in recent and future GDP growth (see Table 1), commenting that near-term growth may be slightly below the trend observed recently.[25] He further stated:

> I am very much looking forward to the day when I can come here and say, 'I think growth is clearly going to be above trend now', but I cannot quite say that about the next year just yet.[26]

2.17 Noting that the forecast had reduced by 0.25 per cent from December 2013, the Governor commented 'I do not think we have had a radical rethink on growth'.[27] He stated:

> The forecasters always give us their best guess, and sometimes it goes up and sometimes it goes down. It has gone down a bit lately.

24 RBA, *Statement on Monetary Policy*, August 2014, p. 4.

25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 5.

26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 5.

27 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 5.

> A quarter per cent difference – I do not really regard that as a terribly significant thing.[28]

The cash rate

2.18 The RBA Board decided to leave the cash rate unchanged at two and a half per cent at its meeting on 5 August 2014. At the public hearing the Governor compared the current cash rate to previous levels, noting that it is at its lowest rate for 50 years and has held there for a year now. He commented that the cash rate is expected to remain consistent for some time yet.[29] He later added:

> I want to be clear… that despite speculation in various quarters, we have not thought about raising rates any time lately.[30]

2.19 The Governor was asked by the committee for his views on the factors likely to encourage economic growth outside the resources sector. The Governor commented that lowering cash rates was unlikely to encourage growth, although it could be considered under appropriate circumstances.[31] However, he further stated:

> I do not really think interest rates are the answer, really, just at the moment… I do not think, to the extent that the economy has some ailments, that it is because interest rates are punishingly high. I think we need this environment where there is more confidence to move ahead. I cannot make that happen. I have allowed the horse to come to the water of cheap funding. I cannot make it drink.[32]

The exchange rate

2.20 In its August 2014 Statement on Monetary Policy the RBA outlines general trends in the exchange rate since the previous Statement. It comments that the Australian dollar had seen little change on both a trade-weighted basis and against the US dollar, while the exchange rate remains high by historical standards.[33] The RBA states:

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28 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 5.

29 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.

30 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 12.

31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 20.

32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 20.

33 RBA, *Statement on Monetary Policy*, August 2014, p. 2.

> The exchange rate is well above its level in late January, notwithstanding the decline in commodity prices and a narrowing in the interest rate differentials between Australia and most other advanced economies since then.[34]

2.21 At the hearing, the Governor was asked by the committee what events or developments could trigger a fall in the exchange rate. The Governor responded:

> It is very hard to say what developments will at some point trigger a fall. It does remain my view that, on most metrics that you would look at… it is going to be pretty surprising if it remains this high over a very long period.[35]

2.22 The Governor was then asked in what circumstances the RBA would consider direct intervention to lower the exchange rate. He stated that this measure has not been adopted to date,[36] and remarked:

> But put it this way: if intervention is to be a useful tool, in my opinion it is most useful when you do not set out in detail what conditions it would take to get you to do it because that might get people to relax just a little bit too much in the near term. My view is that it is on the table as a possibility if it seems appropriate. I am not going to give advance warning to the world's investors about when it might be done—if you don't mind! I think that would be a tactical mistake on my part.[37]

2.23 The Governor further commented on the issue of intervention, stating:

> There was a point when the exchange rate was much higher than it is now where I thought about it seriously, but then the exchange rate went down and we have not revisited that level… What we have said is we certainly do not rule out the possibility of intervention under some circumstances.[38]

2.24 The Governor was also asked for his views on the factors causing the Australian dollar to stay high. He commented:

> There is a range of reasons but the most fundamental one, I think, has to be that in some sense our country, in the eyes of the global capital market over the past five years, probably approaching 10, has had a re-rating. We are more attractive, partly because other

34 RBA, *Statement on Monetary Policy*, August 2014, p. 2.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 4.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 4.

37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 4.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 14.

> countries are less attractive. It is also partly because of our trade fundamentals with the terms of trade with mining, et cetera, looking different to the way they used to…. All these things go to part of the story of why it has been quite high. That said, it still strikes me that I cannot see the logic for it not being a bit lower at some point than it is today. I cannot tell you when though.[39]

Inflation

2.25 The Governor noted in his opening statement that consumer prices had risen by three per cent over the year to June and that this was a faster pace than the previous year. He commented that:

> This partly reflects factors like the increase in the tobacco excise, but measures of underlying inflation also increased. A faster pace of increase in prices for tradeable goods and services was a feature, and that is a reflection of course of the depreciation of the exchange rate since April last year.[40]

2.26 The Governor remarked that the falling growth of labour costs, having reached its lowest rate for many years, has contributed to a decline in the inflation rate for non-tradables over the past year.[41] He also noted:

> The depreciation in the currency last year is likely to continue to contribute to higher prices for tradables for a while yet, but domestic inflation we think is likely to remain contained given how slowly labour costs have been rising.[42]

2.27 In discussing the likely impacts on inflation over the coming year in his opening statement, the Governor noted that the removal of the price on carbon would lower inflation temporarily.[43] The Governor was then asked by the committee what the effect of a reintroduction of a price on carbon would be. The Governor responded:

> … if you put the price on carbon back where it was, then the price level will go back to where it was before, roughly speaking. So that would be a repeat of the introduction of the carbon price in 2012. That had no implication for interest rates either up or down because, just as when we had the GST in 2000, when there is an

39 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 8.

40 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 2.

41 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 2.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, pp. 2-3.

43 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 3.

> identified policy change that clearly has a one-time price level effect, we do not think we can offset that by raising interest rates, or lowering them if it is going the other way, and nor should we. That is a temporary effect on the rate of inflation, not a permanent one, unless it feeds into expectations of ongoing inflation.[44]

2.28 The committee asked the Governor whether the low interest rate environment may drive riskier investment behaviour. He commented:

> Very good question. When I say that monetary policy has to be set with an eye to our mandate for full employment and price stability but also has to take into account financial stability considerations, these are the sorts of things I mean. It is how monetary policy works, when we are expansionary, that we are prompting people to substitute out the yield curve and out the risk curve. That is part of how it works. There is a lot of discussion globally about how terrible this is. Actually, it was—up to a certain level, anyway—the whole point of the very accommodative policies being run in so many jurisdictions. The point was to get people to take more risk, because they went from taking too much to taking none, and we want to go back part of the way. But when I am thinking about how low rates should be it is in my mind, 'How many pensioners do I want to push into slightly higher risk assets? Do they realise what these risks are?'
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> We have housing prices rising pretty smartly. I hope you know my nuanced position on that. I have explained that before. But do I really want to speed this up a whole lot more? Could that turn out quite badly? These are things that one thinks about. In the end we have to find a balance, and this is the one we have struck. I think it is right but I realise that other people will have different opinions. Those are the considerations that we have to take on board.[45]

Labour

2.29 In his opening statement, the Governor remarked that the unemployment rate had been recorded at a higher level and commented that ‘though most leading indicators of the labour market seem to have improved a little this year… it will be a while before we see sustained reductions in the rate of unemployment.’[46]

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 17.

45 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 21.

46 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 2.

2.30 The committee noted from the RBA's August 2014 Statement on Monetary Policy that a reduction in this rate is not forecast until 2016 and that this contrasts with the mention of an expected improvement in late 2015 at the previous hearing in March. Dr Christopher Kent, Assistant Governor (Economic) of the RBA, commented that:

> …we really have not changed the timing of when we might see the unemployment rate start to move lower, with all the uncertainty. That is around late 2015 or early 2016. But there is much uncertainty about that. Earlier in the year, we saw the unemployment rate drop somewhat surprisingly from six to about 5.8, and I think, prematurely, a number of people—not us—called it, and said, 'We've seen the peak.' The picture we paint of the economy is one where the economy will be generating employment growth but just not enough to make inroads into the unemployment rate.[47]

2.31 The committee asked the Governor whether the unemployment rate could increase to a rate closer to seven per cent than the current forecast. The Governor commented that:

> It will always be possible to construct a scenario that will deliver you that rate or even higher, if you want to do so. I would put a scenario where the animal spirits never recover, where non-mining investment stays as weak as it is now indefinitely—and it is quite weak—and the exchange rate stays at this high mark at a pretty low likelihood as an outcome myself.[48]

2.32 The committee noted that for the first time since 2007, Australia's unemployment rate is higher than that of the United States of America, and sought the Governor's comment. The Governor remarked that:

> They have been recovering, which is a good thing, and they have been, this year particularly, generating a pretty good pace of job growth. We have generated better job growth this year than we were in the second part of last year, but still I would like to see it a bit higher. So our unemployment rate has been drifting up while theirs for some years now has been drifting down, from quite high levels to in the low sixes.[49]

2.33 The Governor further commented:

> I am quite concerned at the thought that unemployment is higher. I think we could sustain a lower one. I think there should be

47 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript*, 20 August 2014, p. 6.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 9.

49 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 13.

appropriate circumspection about our ability to just engineer that in a short period, but our mandate talks about full employment as well as price stability. I have to keep both these goals in mind and I think the inflation target framework is a good one for keeping both those goals in mind.[50]

2.34 The Governor was asked by the committee for the RBA's view on real wages over the last three to four years. He responded:

> Measured by the wage price index, which I think is generally seen as the best fixed weight measure of labour costs, it is rising at about 2½. The underlying inflation rate is a little higher than that over the past year, so that is little or no change or a small fall in real wages over that year. Prior to that, they were probably growing a little bit but modestly.[51]

2.35 Dr Kent also commented on the recent decrease in wages in real terms[52] stating:

> That has happened in the past and it happened most recently in the GFC but, as the governor suggested earlier, this is part of the important adjustment. The labour market is showing a degree of response to the subdued conditions. Wage growth is lower than it otherwise would be and therefore employment is stronger than it otherwise would be.[53]

2.36 The committee noted the low growth in wages and questioned whether this would constrain consumption and domestic demand. The Governor noted that 'some people say that low wages growth will impair consumption, and that has to be arithmetically true if everything else remains constant'.[54] However, he went on to explain:

> … if you think through more of the connections—low wages growth; low inflation; actually, cost of living goes up more slowly, which helps real income—it also helps save jobs… I would argue, that what we are seeing in the behaviour of labour costs is that it is quite responsive to a soft-looking labour market. That is a good thing in the sense that it helps conserve employment. More people in jobs—that has to be a better outcome. And those people also consume. So there are a number of things going on in this rather complex equation, and, when you think through all those things, I

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 16.

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 9.

52 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript*, 20 August 2014, p. 9.

53 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript*, 20 August 2014, pp. 9-10.

54 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 20 August 2014, p. 6.

> do not see, at this point, a 2½ per cent rise in the wage price index, say, as a thing that is seriously impairing growth. In some ways, I think it is actually helping the economy deal with the situation that we face. So that does not worry me so greatly.[55]

Housing

2.37 In respect of the residential property market, the Governor was asked whether he thought there was any action that should be taken to address recent price increases in particular city markets and large increases in borrowing by investors. He noted that aside from stepped-up scrutiny by APRA of leverage and lending standards, the strongest available action would be the use of macro-prudential tools. In respect of the circumstances in which he would consider the use of macro-prudential tools, the Governor responded:

> I guess where you felt that impressing on managements the need for strict standards was not effective enough—if there was a sense that there was a significant financial and economic risk building here. They are the sorts of circumstances in which you would use them. Also, at some point interest rates might not be as low as they are today, which will have a bearing too. That seems unlikely on any near-term horizon, as I have already said, but those things that are also on the far-distant horizon have to remain on the table too.[56]

Small business

2.38 The Governor was asked by the committee for his views on the availability of credit to small business. He noted that 'credit to small business is inherently hard',[57] explaining:

> The credit assessment process is difficult to do for an entity that has no track record. That is presumably why a lot of the funding of small business is basically equity or it is debt secured against a dwelling… it would be good to have more discussion about

55 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 6.

56 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 21.

57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 14.

> business, and small business in particular. But I do not have a magic-bullet solution to offer.[58]

2.39 The committee then enquired as to the effect of the Basel III global banking reforms on access to finance for small business. The committee noted, in particular, the interim finding of the Financial System Inquiry:

> In the view of the Inquiry, high-quality projects and viable enterprises would still be able to obtain funding through other channels if insufficient credit was available. But it acknowledges entities that are more reliant on loans, such as small businesses, would have some difficulty accessing funding.[59]

2.40 In commenting on the issue of credit growth constraints, the Governor noted that:

> I think this whole debate got a bit skewed when, through the financial crisis, the costs of wholesale funding escalated quite quickly because of global market developments… I do not think it contains a lot of information about the ability of the financial system to fund the credit growth that goes with normal healthy rates of growth in the economy in a non-crisis environment. So I do not think the problem that is being posited is really a problem. Having said that, the other point that the inquiry is making here, which you read out, is valid. Even if you thought the banks were not going to be able to provide funding for business, a really big business can get it somewhere else, and that is true; a really small business cannot… What you do about this narrowness of opportunities for small business is an acknowledged problem. I agree with that. I do not have an obvious solution.[60]

2.41 The committee also sought the Governor's view on whether banks are being particularly conservative in small business lending. The Governor noted that the banks appeared to be engaging in less conservative lending.[61] He further remarked in this regard that 'I think they are trying harder now than they were, because they want growth themselves. And I think to some extent that is a welcome development, provided that standards remain good'.[62]

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58 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 14.

59 Financial System Inquiry, 'Interim Report', <http://fsi.gov.au/publications/interim-report/> viewed 4 August 2014, Chapter 2, p. 79.

60 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 15.

61 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 14.

62 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 14.

2.42 The Governor also commented on the role of small business in the dynamism of the economy. He noted that small enterprises employ the bulk of the workforce and commented:

> In our national debate it is easy for us to become focused on where the jobs are going and where the industries are shrinking. Without in any way denying that that is very painful for those people, there is another side to that, which is that there are new things happening. We do not read about these because they are often small, they are often busy getting on with things, and they are not cultivating the media to tell their story in the same way. But they are there. In that sense, I would share your optimism that provided there is an environment, as Philip said before, where the risk-takers and the entrepreneurs have the opportunity, the incentives and the flexibility, this is all good, and you could be confident in ways that we cannot imagine. Employment and economic activity will grow into the future. I cannot sit here today and tell you what sector exactly—that is the inherent frustration of this.[63]

Conclusion

2.43 While it is pleasing that growth is expected in the economy over the next few years, the rate of growth continues to be below historical trends. Australia's trading partner growth is forecast to be above its long run average, in part due to strong export trade to China. The exchange rate remains high but is not causing sufficient concern to warrant the RBA's intervention. The unemployment rate continues to be high, with the labour market responding to these conditions with slow growth in wages. However, there are positive indicators of a lower unemployment rate in coming years. The Government and the RBA must continue to monitor developments to best provide a policy and regulatory framework to foster growth, particularly in the non-mining sectors.

Kelly O'Dwyer MP
Chair
22 October 2014

63 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 20 August 2014, p. 19.

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Wednesday, 20 August 2014 – Brisbane

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Dr Philip Lowe, Deputy Governor
Dr Christopher Kent, Assistant Governor (Economic)

Private briefing

Wednesday, 16 July 2014 – Canberra

Mr Stephen Walters, Chief Economist, JP Morgan

B

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

The Treasurer and the Governor of the Reserve Bank

24 October 2013

The Statement on the Conduct of Monetary Policy (the Statement) has recorded the common understanding of the Governor, as Chairman of the Reserve Bank Board, and the Government on key aspects of Australia's monetary and central banking policy framework since 1996.

The Statement seeks to foster a sound understanding of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Reserve Bank.

The centrepiece of the Statement is the inflation targeting framework, which has formed the basis of Australia's monetary policy framework since the early 1990s.

The Statement has also been updated over time to reflect enhanced transparency of the Reserve Bank's policy decisions and to record the Bank's longstanding responsibility for financial system stability.

Building on this foundation, the current Statement reiterates the core understandings that allow the Bank to best discharge its duty to direct monetary policy and protect financial system stability for the betterment of the people of Australia.

Relationship between the Reserve Bank and the Government

The Reserve Bank Governor, its Board and its employees have a duty to serve the people of Australia to the best of their ability. In the carrying out of their statutory obligations, through public discourse and in domestic and international forums, representatives of the Bank will continue to serve the best interests of the people of Australia with honesty and integrity.

The Governor and the members of the Reserve Bank Board are appointed by the Government of the day, but are afforded substantial independence under the *Reserve Bank Act 1959* (the Act) to conduct the monetary and banking policies of the Bank, so as to best achieve the objectives of the Bank as set out in the Act.

The Government recognises and will continue to respect the Reserve Bank's independence, as provided by the Act.

The Government also recognises the importance of the Reserve Bank having a strong balance sheet and the Treasurer will pay due regard to that when deciding each year on the distribution of the Reserve Bank's earnings under the Act.

New appointments to the Reserve Bank Board will be made by the Treasurer from a register of eminent candidates of the highest integrity maintained by the Secretary to the Treasury and the Governor. This procedure ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act, which requires the Reserve Bank Board to conduct monetary policy in a way that, in the Reserve Bank Board's opinion, will best contribute to:

a. the stability of the currency of Australia;
b. the maintenance of full employment in Australia; and
c. the economic prosperity and welfare of the people of Australia.

These objectives allow the Reserve Bank Board to focus on price (currency) stability, which is a crucial precondition for long-term economic growth and employment, while taking account of the implications of monetary policy for activity and levels of employment in the short term.

Both the Reserve Bank and the Government agree on the importance of low inflation.

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

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

The Governor expresses his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving medium-term price stability.

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

Transparency and Accountability

Transparency in the Reserve Bank's views on economic developments and their implications for policy are crucial to shaping inflation expectations.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. These steps include statements announcing and explaining each monetary policy decision, the release of minutes providing background to the Board's policy deliberations, and commentary and analysis on the economic outlook provided through public addresses and regular publications such as its quarterly *Statement on Monetary Policy* and *Bulletin*. The Reserve Bank will continue to promote public understanding in this way.

In addition, the Governor will continue to be available to report twice a year to the House of Representatives Standing Committee on Economics, and to other Parliamentary committees as appropriate.

The Treasurer expresses support for the continuation of these arrangements, which reflect international best practice and enhance the public's confidence in the independence and integrity of the monetary policy process.

Financial Stability

Financial stability, which is critical to a stable macroeconomic environment, is a longstanding responsibility of the Reserve Bank and its Board.

The Reserve Bank promotes the stability of the Australian financial system through managing and providing liquidity to the system, and chairing the Council of Financial Regulators (comprising the Reserve Bank, Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury).

The Payments System Board has explicit regulatory authority for payments system stability. In fulfilling these obligations, the Reserve Bank will continue to publish its analysis of financial stability matters through its half-yearly *Financial Stability Review*.

In addition, the Governor and the Reserve Bank will continue to participate, where appropriate, in the development of financial system policy, including any substantial Government reviews, or international reviews, of the financial system itself.

The Reserve Bank's mandate to uphold financial stability does not equate to a guarantee of solvency for financial institutions, and the Bank does not see its balance sheet as being available to support insolvent institutions. However, the Reserve Bank's central position in the financial system, and its position as the ultimate provider of liquidity to the system, gives it a key role in financial crisis management. In fulfilling this role, the Reserve Bank will continue to coordinate closely with the Government and with the other Council agencies.

The Treasurer and the Governor express their support for these longstanding arrangements continuing.

C

Appendix C — Glossary of terms

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.

Basel III global banking reforms. A set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector globally.

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.

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

capital market. A market for medium to long-term financial instruments. Financial instruments traded in the capital market include shares, and bonds issued by the Australian Government, State governments, corporate borrowers and financial institutions.

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.

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.

exchange rate. The price of one currency expressed in terms of another currency. Any exchange rate can be quoted two ways, e.g. Australian dollars per US dollar (USD/AUD) or US dollars per Australian dollar (AUD/USD). The convention for the Australian dollar is that it is quoted as the foreign currency price of the Australian dollar. This is sometimes referred to as the 'Indirect' method of quoting.

Financial System Inquiry. The inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth. The terms of reference for the inquiry were announced on 20 December 2013.

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 market. A collective term for employment, unemployment, participation rates and wages.

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.

non-tradables. Non-tradables refers to things that are not readily exported or imported, like medical services, housing and haircuts. As such, their prices are largely determined domestically. By comparison, tradable items are things whose prices are largely determined on the world market like oil, motor vehicles and clothing. As such, the prices of tradable items are heavily influenced by exchange rate movements, whereas the prices of non-tradables largely reflect domestic factors.

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.

quantitative easing. Quantitative easing involves central banks purchasing financial assets (such as government bonds, corporate bonds and mortgage-backed securities). It increases the money base with a view to driving down long-term borrowing costs.

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

real interest rate. The real interest rate refers to the cost of borrowing money (i.e. the nominal interest rate) net of inflation. It takes account of the fact that part of the nominal interest that borrowers pay to lenders represents compensation for anticipated inflation. The remaining ‘real’ component better reflects the economic cost of borrowing and the return to lending.

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

reserve bank reserve fund. The bank's permanent general reserve, established by the Reserve Bank Act. Sums are credited to the fund from earnings available for distribution, as determined by the Treasurer after consulting the Reserve Bank Board. The balance of distributable earnings after any such transfer is payable as a dividend to the Commonwealth. The fund is essentially the bank's capital. Its primary purpose is to provide a capacity to absorb losses when it is necessary to do so.

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.

tradables. Tradable items are things whose prices are largely determined on the world market like oil, motor vehicles and clothing. As such, the prices of tradable items are heavily influenced by exchange rate movements. By comparison, non-tradables refers to things that are not readily exported or imported, like medical services, housing and haircuts. As such, their prices are largely determined domestically.

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.

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