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

House of Representatives
Standing Committee on Economics

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Chair's foreword

On 3 February 2015 the RBA lowered the official interest rate for the first time in 18 months from 2.5 to 2.25 per cent. At the public hearing on 13 February 2015, the Governor commented that this decision was taken because of a more sustained period of below trend growth than previously forecast, a higher peak in unemployment, and slightly lower inflation.

The lower interest rate is expected to provide some support to demand in the short term although the Governor noted at the hearing that the capacity for monetary policy to do so is perhaps lower than it used to be. The non-resources sectors and Australia's growing trade partnerships with Asia are most likely to generate GDP growth in the long-term.

Current labour conditions in Australia are still somewhat subdued and the unemployment rate is expected to peak later than previously anticipated. Dr Christopher Kent of the RBA commented at the hearing that 'with the prospect that growth will remain at current levels for a little bit longer than we had hoped, the unemployment rate will rise a bit from here.'

The Australian dollar has depreciated considerably against the US dollar in recent months which is expected to benefit the traded sectors of the economy. However, the RBA has commented that our dollar still remains above most estimates of its fundamental value. The exchange rate is therefore expected to adjust further and this will depend to a large degree on how far the terms of trade fall.

It is encouraging to note the Governor's view that productivity growth has begun to improve. The committee is also mindful of the Governor's comments at the hearing that Australia's public sector debt needs to be kept low so that, as he explained, 'when something big goes wrong and the government wants to expand fiscal policy to help the economy, like we did in 2009, you want the scope to do that.'

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 13 February 2015.

John Alexander OAM MP
Chair

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Membership of the Committee

Chair	Mr John Alexander OAM 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 Member	The Hon Tony Smith MP

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Dr Kilian Perrem
Research Officer	Ms Marina Katic
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	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.

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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 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 first public hearing in relation to the committee's examination of the RBA's 2014 Annual Report was held in Hurstville, Sydney on 13 February 2015.

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

1.6 Before the hearing, the committee received a private briefing from Mr Rory Robertson, Analyst, Westpac Group Treasury. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Robertson'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 Sydney on 13 February, and also draws on issues raised in the RBA's February 2015 *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_2014_Annual_Report/Public_Hearings> viewed 20 February 2015.

3 Reserve Bank of Australia, 'Statement on Monetary Policy', <http://www.rba.gov.au/publications/smp/index.html> viewed 20 February 2015.

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Monetary policy and other issues

Overview

2.1 On 3 February 2015 the Reserve Bank of Australia (RBA) decided to lower the official interest rate to 2.25 per cent, effective 4 February 2015, after 18 months of stability at 2.5 per cent. In his statement on the decision, the Governor noted that:

> … the Board judged that, on balance, a further reduction in the cash rate was appropriate. This action is expected to add some further support to demand, so as to foster sustainable growth and inflation outcomes consistent with the target.[1]

2.2 The Governor remarked at the public hearing on 13 February 2015 that there were fewer indicators of a future boost in growth in the non-mining sector than had been expected at this stage:

> Overall, then, growth in non-mining economic activity has picked up over the past year, but it is still running a bit below average pace.
>
> Our expectation had been that a further pick-up would occur in 2015. When we reviewed our forecasts in late January we did not feel that growth thus far had been weaker than we had expected three or six months ago we, but, when we looked forward, as hard as that is to do, we felt that there were fewer signs of a further pick-up in non-mining activity than we had hoped to see by now.[2]

2.3 In the RBA's statement the Governor noted that generally the RBA expected growth to continue at a 'below-trend pace, with domestic

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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/2015/mr-15-01.html>.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

demand growth overall quite weak'.[3] He further noted that this had contributed to a gradual increase in unemployment, and while the decrease in energy prices may offer significant support to consumer spending, the decline in the terms of trade is reducing income growth at the same time:

> Overall, the Bank's assessment is that output growth will probably remain a little below trend for somewhat longer, and the rate of unemployment peak a little higher, than earlier expected. The economy is likely to be operating with a degree of spare capacity for some time yet.[4]

2.4 During the public hearing, the Governor commented on the expansion of the Australian economy within an international context:

> … since we met in August last year the economy has continued to grow at a moderate but below-trend pace… The international context is one in which the global economy likewise is growing, but according to most observers at a pace a little below its medium-term trend.[5]

2.5 Additionally, the Governor noted that inflation is quite low in a range of countries and likely to remain low over the period ahead. This is partly due to changes in energy prices and government policy.[6]

2.6 The Governor stated that commodity prices have fallen in the past three months, and quite sharply in the case of iron ore. This is due, in part, to major increases in supply. He added that the effect of this on individual countries will vary, however, it is a positive development for the global economy more broadly.[7]

2.7 The Governor reported on the differences in the recent economic performances of various global economies and their impact. He remarked that while the US economy is growing above trend and China's economy met its growth target in 2014, the Euro area and Japan have recorded lower growth than expected.[8] He commented on the overall impact these differences may have on financial market conditions:

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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/2015/mr-15-01.html>.

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/2015/mr-15-01.html>.

5 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 1.

6 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, pp. 1-3.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, pp. 1-2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 2.

> … the monetary policies of the major jurisdictions look like they will be heading in different directions. That means there is ample potential for further turbulence in financial markets this year.[9]

2.8 The Governor commented that the current capacity for monetary policy to increase demand with lower interest rates may be less effective than in the past:

> A decade ago, when there was, it seems, an underlying latent demand continually among households to borrow and spend, it was perhaps easier to generate additional demand in the economy by lowering interest rates. Today, that channel may not be quite as effective as it was then. Nonetheless, we do not think at this point that monetary policy has reached the stage where it has no ability at all to give additional support to demand in the economy. Our judgement is that it still has some ability to do that and to assist the transition the economy is making, and we regarded it as appropriate to provide that support.[10]

2.9 During the hearing, the committee questioned the Governor and the other RBA officials who appeared on monetary and economic policy frameworks and their impacts. Areas of discussion included the cash and exchange rates, inflation, the labour market, housing, productivity growth, public sector debt and the growth performance of Australia's major trading partners.

Forecasts

2.10 In its February 2015 *Statement on Monetary Policy*, the RBA forecasts growth of Australia's major trading partners (MTPs) to be around its long run average in 2014 and 2015:

> Growth in China is expected to be a little lower in 2015, while growth in the US economy is expected to pick up further. The significant fall in oil prices, which has largely reflected an increase in global production, represents a sizeable positive supply shock for the global economy and is expected to provide a stimulus to growth for Australia's MTPs.[11]

2.11 Further to this, in its February 2015 Statement the RBA forecast Australian GDP growth to 'remain a bit below trend over the course of this year,

9 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 2.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

11 RBA, *Statement on Monetary Policy*, February 2015, p. 1.

before picking up to an above-trend pace in the latter part of the forecast period as consumption growth improves, non-mining business investment lifts and LNG (liquefied natural gas) exports increase'.[12] The RBA adds:

> Notwithstanding the recent falls in oil prices, new information suggests that consumption growth and non-mining business investment are likely to pick up later than previously had been expected, and that LNG production is likely to ramp up a bit more gradually than earlier expected. Lower export prices are expected to dampen the growth of incomes and activity. In time, however, the recent further depreciation of the exchange rate and lower interest rates are expected to provide support to demand. As a result, GDP growth is expected to be above trend in the latter part of the forecast period.[13]

2.12 The RBA Statement further indicates that while the leading indicators of labour demand have improved since late 2013, only modest employment growth and a slight rise in the unemployment rate in the near term is likely:

> Although the most recent data on the labour market have been more positive, including stronger employment growth, measures of spare capacity have increased over the past year, consistent with a continuation of below-trend growth in economic activity. In particular, the unemployment rate increased gradually over 2014, continuing its trend of the past few years, and the participation rate and average hours worked remain below their levels of a few years ago.[14]

2.13 The Governor noted in his opening statement that inflation was low and expected to remain so over the forecast horizon, stating:

> … the inflation outlook was revised very slightly lower—in part, that is the effect of declining oil prices and also, at the margin, the weaker outlook for economic activity.[15]

2.14 The Statement also reported a decline in underlying inflation to around 2¼ per cent in year-ended terms,[16] forecasting that 'underlying inflation is expected to remain well contained and consistent with the target throughout the forecast period'.[17]

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12 RBA, *Statement on Monetary Policy*, February 2015, p. 3.

13 RBA, *Statement on Monetary Policy*, February 2015, p. 3.

14 RBA, *Statement on Monetary Policy*, February 2015, p. 2.

15 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

16 RBA, *Statement on Monetary Policy*, February 2015, p. 2.

17 RBA, *Statement on Monetary Policy*, February 2015, p. 3.

2.15 The RBA notes in its Statement that Consumer Price Index (CPI) inflation decreased to 1.7 per cent over the year to the December quarter, partly reflecting the direct effect of the large fall in oil prices and the repeal of the carbon price.[18] The RBA further comments:

> The outlook for consumer price inflation has been revised lower since the previous Statement, reflecting the effects of the fall in oil prices and the weaker outlook for labour and product markets.[19]

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

Year-ended							
		Dec 2014	**June 2015**	**Dec 2015**	**June 2016**	**Dec 2016**	**June 2017**
GDP growth		2½	2¼	2¼–3¼	2¾-3¾	3-4	3-4½
Non-farm GDP growth		2¾	2¼	2¼–3¼	2¾-3¾	3-4	3-4½
CPI inflation[(b)]		1.7	1¼	2-3	2¼–3¼	2¼–3¼	2¼–3¼
Underlying inflation[(b)]		2¼	2¼	2-3	2-3	2-3	2-3
Year-average							
		2014	**2014/ 2015**	**2015**	**2015/ 2016**	**2016**	**2016/ 2017**
GDP growth		2¾	2¼	1¾-2¾	2½–3½	2¾-3¾	2¾ -4¼

(a) Technical assumptions include A$ at US$0.78, TWI at 64 and Brent crude oil price at US$59 per barrel.

(b) Based on current legislation

Source *Reserve Bank of Australia, Statement on Monetary Policy, February 2015, p. 71*

2.16 At the hearing, the Governor discussed trends in recent and future GDP growth (see Table 1), commenting that the forecasts at the RBA's February board meeting suggested 'a longer period of below trend growth and a higher peak in the rate of unemployment than earlier forecasts.'[20] He commented on the RBA's decision to adjust monetary policy further in response to these forecasts:

> At its meeting in February, the board considered that this revised assessment—that is, sub-trend growth for a bit longer, a higher peak in the unemployment rate and slightly lower inflation—

18 RBA, *Statement on Monetary Policy*, February 2015, p. 2.

19 RBA, *Statement on Monetary Policy*, February 2015, p. 3.

20 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

> warranted consideration of some further adjustment to monetary policy after a fairly long period in which the cash rate had remained steady. These forecast adjustments were incremental, but they were all in a consistent direction so far as monetary policy is concerned.[21]

2.17 The Governor noted the trend that unemployment has been increasing at a quarterly rate of approximately 0.10 per cent, commenting that 'we can sustain lower rates of unemployment than this, in my opinion, and we should be seeking to do so.'[22] He further stated:

> Really, the economy needs a bit more growth than we presently have. That is what we are trying to encourage within the limits of our powers, and other policies need to do that too.[23]

2.18 The RBA further commented on factors that are likely to improve GDP growth more broadly in the future:

> Ultimately, GDP growth comes from growth in the size of the workforce, growth in the size of the capital stock and the efficiency with which we use the capital and labour that we have.[24]

The cash rate

2.19 The RBA Board decided to lower the cash rate from 2.5 per cent to 2.25 per cent at its meeting on 3 February 2015 which was the first rate change since August 2013. At the public hearing, the committee asked the Governor to identify the economic indicators that prompted the move away from a period of stability in interest rates. The Governor responded:

> I would go back to the articulation of a revision to the outlook. A year ago, we had been sitting still for a little while and saying, 'Our best guess is we will be sitting still for a while longer.' I think at that stage we had a number of indications that confidence was improving. It was a reasonable forecast at that stage that non-mining activity, which at that point was still on the subdued side, was going to firm and I think the evidence was panning out that way.
>
> In the second half of the year, I think that faded a little bit—not disastrously, but there was follow-through that one might have

21 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.
22 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 4.
23 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 4.
24 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript,* 13 February 2015, p. 15.

> hoped was not quite there. As I said earlier, it is not so much that growth thus far has been seriously weaker than expected; it is more that by now I would have hoped to have seen a few more signs than we do see of further pick-up in intentions to invest and employ. We have seen some pick-up in those things, but I think by now it would have been good to have seen some more.[25]

2.20 In relation to the broader international context, the Governor noted that the very low interest rates discussed at the RBA's last appearance before the committee have since fallen even further around the world,[26] later adding:

> … long-term interest rates in the global economy are probably, to the best that I can tell, the lowest in recorded human history.[27]

2.21 The Governor went on to explain that although the easing of the interest rate is expected to provide some additional support to demand, it was unlikely to generate long-run sustainable growth. He went on to identify likely sources of sustained growth in the future:

> I think it is fair to say that monetary policy is no silver bullet for everything that is wrong… We will do what we can do within the limits of our mandate and our powers, but long-run sustainable growth is not going to come from manipulating interest rates or… It is going to come from some of the other things that we talked about earlier: innovation, productivity and risk-taking, in the best sense of that word… That is ultimately the source of the sustained growth here. Monetary policy is about demand management within the cycle. It is not a perfect instrument, but we use it as best we can. But those other things, which do go to structural matters, among others, are the source of long-run prosperity.[28]

2.22 The committee asked the RBA officials what measures could be taken to encourage household consumption, business investment and the construction sector to contribute more to GDP growth. Dr Christopher Kent, Assistant Governor, commented that while key elements are already in place to boost growth through business investment outside the mining sector, improvements in this area are unlikely to occur in the near term:

> We do not see business investment outside the mining sector picking up in the next few quarters; it is some time a bit further out from that. Construction, of course, is a very important part of

25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, pp. 5-6.

26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, p. 2.

27 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, p. 9.

28 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, p. 15.

> that. One of the soft bits of data of late has been non-residential building approvals, which have come off a little bit. In any case, I think there are reasonable grounds to expect that non-mining business investment will pick up. We just do not think that will happen in the near term.[29]

The exchange rate

2.23 In its February 2015 Statement on Monetary Policy the RBA outlines general trends in the exchange rate since the previous Statement. It comments that the Australian dollar has depreciated by around nine per cent against the US dollar and by seven per cent on a trade-weighted basis.[30] The exchange rate has depreciated further recently, but still remains above most estimates of its fundamental value.[31] The RBA's February 2015 Statement states that 'the depreciation of the exchange rate since mid 2014 should provide a boost to services and manufactured export volumes'.[32]

2.24 At the hearing, the Governor reported that the Australian dollar has fallen against the relevant currencies by about 11 per cent since the committee's last hearing in August.[33] The committee was interested in the impact of the lower Australian dollar on exporters and Australian manufacturers. The Governor responded that 'the decline in the exchange rate will be helpful to the traded sector and I think we will see the evidence of that get clearer over the period ahead'.[34]

2.25 The committee asked the Governor how effective a decrease in the exchange rate was in stimulating economic growth, compared to easing monetary policy by lowering interest rates. The Governor explained that the mechanism by which the exchange rate contributes to growth in the economy is by offsetting other contractionary influences, for example, the recent decline in Australia's terms of trade:

> The world economy has delivered us a decline in terms of trade et cetera. That is the force to which the exchange rate has been responding, as it should. It is doing roughly what it should be

29 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, pp. 7-8.

30 RBA, *Statement on Monetary Policy*, February 2015, p. 2.

31 RBA, *Statement on Monetary Policy*, February 2015, p. 4.

32 RBA, *Statement on Monetary Policy*, February 2015, p. 42.

33 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

34 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 5.

> doing… The question then is: what is the net effect?... The forecast says we will grow in time or pick up to above trend—but not yet.[35]

2.26 The committee noted that the substantively lower Australian dollar had provided less assistance than expected in delivering balanced growth to the domestic economy and asked the Governor for his views on this. He responded:

> Where it [the Australian dollar] goes from here really hinges on how far the terms of trade fall. I think it also hinges a bit on what other countries do. The US is going to be raising rates in three or four months time if they proceed according to their articulated intentions. I think that will change the environment. Some of that should pretty well be priced already. But I think once that begins to happen, if it does, that is probably going to change the tone of financial markets, including exchange markets.[36]

Labour

2.27 In the February 2015 *Statement on Monetary Policy* the RBA reports that the unemployment rate is likely to rise a bit further and peak a bit later than earlier expected, before declining as growth picks up to an above-trend pace.[37] Consistent with this, the RBA reported subdued labour market conditions at the public hearing and estimated that the unemployment rate would continue to increase at its current rate for a few more quarters.[38]

2.28 Mr Kent stated that the RBA's latest forecasts reported the unemployment rate peaking at 6.4 per cent, noting that the RBA included uncertainty ranges in forecast charts for the first time in the February Statement. He added that the wide range around the central tendency in the forecasts reflects a wide margin of uncertainty for the forecasts.[39]

2.29 Furthermore, the RBA officials informed the committee that the youth unemployment rate among 15 – 19 year olds was quite high at approximately 20 per cent, and gave possible reasons for this:

> I think one of the possible reasons for that is that quite a lot of the extra youth who are unemployed are actually looking for part-

35 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 19.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 7.

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

38 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 11.

39 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 11.

> time work and they are in education. So there have been various changes making it easier to get into higher education and also requirements on young people nationally to be in education more so than in the past… It is not to diminish the fact that it is a significant concern.[40]

2.30 In relation to this, the committee was interested in the impact that consumer confidence, business confidence and consumption growth have on unemployment. Mr Kent commented that 'while ever business conditions, business confidence and consumer confidence are around average, it is harder to see a near-term lift in the current growth rate'.[41]

2.31 The committee asked whether the recent fall in petrol prices is a bigger benefit to consumers than the decline in the interest rate to 2.25 per cent. Mr Kent responded that the two elements were 'of a similar sort of order of magnitude'[42] although it was difficult to make direct comparisons of the two factors:

> … you have to be very careful about that analysis, because often what they are doing is just calculating the effect of the lower interest rates on households cash flows given their net debt position, and interest rates work through so many other channels. They work through movements in asset prices, and we have already seen a response over a long period of time, not just in Australia but elsewhere, to very low interest rates. They have some effect on exchange rates, no doubt. They work by encouraging people to save a little bit less and spend a little bit more. So those other analyses making those comparisons usually just do a very simple comparison on the cash flow effect.[43]

2.32 The committee asked RBA officials to explain the relationship between subdued wages growth, household consumption and broader domestic growth, in particular the impact of low wage growth on domestic demand and household consumption. Dr Kent stated that wages growth was expected to remain at its current levels in the near term:

> Our forecast for wages growth is a little bit softer than when we put our forecast together in November. That just reflects that, with the prospect that growth will remain at current levels for a little bit

40 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 15.

41 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 16.

42 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 16.

43 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 16.

> longer than we had hoped, the unemployment rate will rise a bit from here.[44]

2.33 Further to this, Dr Kent remarked that low wages growth 'weighs on household disposable income',[45] noting that employment was growing, although not at the rate of the growing labour force. He added that it was unlikely that wage growth would increase before a boost in consumer and business confidence occurred:

> If you look back at a long history of business cycles, it is very rare for the lead to come from wages; it comes from other things. Lower interest rates certainly push asset prices up, they increase wealth, they help encourage people to drop their savings rate a little bit and to run consumption stronger than income… it is not normal for wages to lead the recovery, to then go to consumption and to then go to business investment. Wages usually come last.[46]

2.34 The committee asked the Governor if there was concern about the declining rate of average and total hours worked, as well as indicators that the underutilisation rate is increasing in the labour market, despite headline unemployment rates appearing optimistic. He stated 'Yes, I think that is a concern'[47] explaining that this information suggested there is significant spare capacity in the economy:

> The whole picture when you put all these bits of labour market things together I think says vacancies are rising, but I would like to see them rising quicker and jobs creation is occurring but really we want that to be more. As you say, average hours have gone down so there is certainly more capacity for labour input to grow if the demand for it is there. We actually need more growth in the economy to use that.[48]

Housing

2.35 In his opening statement, the Governor made note of the continued increase in residential property prices in Australia. He stated that, with the exclusion of Sydney, Australian house prices rose by about five per cent over the past year.[49] In relation to the Sydney property market he added:

44 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 8.
45 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 8.
46 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 8.
47 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 11.
48 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 11.
49 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 3.

> While developments in the Sydney market remain, in my view, of concern, in the end we did not see those trends as overwhelming a case for further easing in monetary policy that was made on more general grounds.[50]

2.36 Further to this, the Governor noted the heightened supervisory activities the Australian Prudential Regulation Authority (APRA) was undertaking to manage the potential risks posed by the rise in residential mortgage lending:

> In brief, they involve more intense scrutiny of investor loan portfolios that are growing above 10 per cent a year, with the possibility ultimately of additional capital requirements if APRA were to deem that necessary. APRA has also reiterated its expectations for other elements of lending standards such as interest-rate buffers, interest-rate floors and so on. ASIC [Australian Securities & Investments Commission] has begun a review of interest-only lending in the context of consumer protection legislation. The bank welcomes those steps and will keep working with the other regulators as necessary in these areas.[51]

2.37 The committee asked the Governor whether allowing the interest component of the mortgages of first homebuyers to be tax deductible would reduce the pressure that interest rate increases place on first home buyers. The Governor responded:

> I would be very wary of doing that, for the following reason. Firstly, there are some people who argue that the tax deductibility of interest for investors prompts more demand by those investors, who push up the prices. If that is true, that is actually detrimental to the interests of the first homebuyers. But I am not sure that the right answer to that problem, if it is a problem, is to extend the tax deductibility.
>
> The other thing to say is that there is already non-trivial public assistance for first homebuyers in the form of grants. But the way that ends up working out is that that money basically ends up in the hands of the vendors of the properties… And I rather fear that if we extend mortgage deductibility we may well end up with a rather similar phenomenon whereby it just results in higher prices… The best solution, surely, for first homebuyers is to borrow within your means. And the banks, if they are doing their

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, p. 3.

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 13 February 2015, p. 3.

> jobs, should test that. And we ought to be able to have confidence that that is being done, and to the best of my knowledge it is.[52]

2.38 In addition to this, the Governor identified supply constraints of well-connected land, particularly in the Sydney area, as a significant factor to be considered when addressing housing affordability for first homebuyers:

> …if we are concerned about the cost of getting a roof over people's heads, the answer to that problem is the one Phil described: more supply of well-located land on which dwellings can be built… with transport, with proper infrastructure so you can commute to your job quickly and so on. In Sydney in particular, this is probably the most serious constraint. I think the state governments are aware of this and are trying to deal with it... We are not short of land in general, but we are short of developable, well-located land connected with transport. That is surely what we have to address.[53]

Productivity

2.39 At the public hearing, the Governor reported on the current trends in productivity growth in Australia:

> … I think productivity growth has begun to improve. I think that is actually in the data now; we can say that. There has been enough of it for a few years to be able to say that yes, from a rather poor previous position, productivity growth has stepped up.[54]

2.40 Further to this, the committee discussed with RBA officials the mechanisms available to drive productivity growth in Australia to ensure labour and capital are used most efficiently. In response, Deputy Governor Dr Phillip Lowe remarked that there was increasing demand in Asia for a number of goods and services that Australia could potentially accommodate. He stated:

> I think developments in Asia here are probably ultimately more important for us. Because there are huge markets there; huge growth in per capita incomes; huge demand for services, and we are very good at producing a whole range of services; and huge demand for clean food, and we are very good at that. So it is the

52 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 24.

53 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 24.

54 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 10.

> growth in Asia and, particularly, our links with Asia. One of the things that I have spoken about before is the people-to-people links. Eight per cent of Australians were born in Asia. And we have hundreds of thousands of students from Asia studying in our country, often going back to their own country and helping build business relationships. That gives us a tremendous base upon which to build, and it is how we best take advantage of that base that we have. There are the questions but, ultimately, they are not for the central bank; they are for the parliament.[55]

Public sector debt

2.41 The committee queried the Governor about his views on the issue of rising public sector debt and its impact on economic growth and employment. He commented that Australia's current debt burden in comparison to global standards was still low.[56] Nevertheless, he noted that it would be prudent to change Australia's public debt trend in the medium term:

> … this is not a crisis immediately, it is a trajectory that we should be looking to change for the medium term. Since it is hard to do, I would be starting ASAP with measures that start small but build up over time. We have said that consistently.[57]

2.42 The Governor commented that borrowing conditions for the Australian Government are currently very favorable.[58] He noted that this will not always be the case, and introducing public debt reform immediately while the conditions of the capital markets are accommodative affords the Australian Government the flexibility to consider various measures that can effectively reduce public sector debt over time:

> … capital markets change, conditions will not be this benign forever, and they can change quickly. So, while we have the time and the flexibility, now is the moment to think about and talk about and enact measures that will gradually get us onto a better trajectory than the one we are otherwise going to be on. That is what I am saying. The going is good now; use that good going to have a course change that will in due course get us onto the better track. Do not wait until the bad signals from the markets come.[59]

55 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript,* 13 February 2015, p. 15.

56 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 9.

57 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 17.

58 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 9.

59 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 17.

2.43 Additionally, the Governor commented that less public debt will ensure scope is available to expand fiscal policy to assist the economy in potential future economic downturns, when less borrowing discretion is afforded to the government by financial markets:

> … suppose we did have a significant downturn in the economy. The budget deficit would go from two per cent of GDP to five or six, in a heartbeat. That would happen very quickly if we had a serious downturn. I am not forecasting that; I am actually trying to prevent that… At that point, we would then be adding to the debt much more quickly than we are at present. And whichever government finds itself in office when that has occurred… will find much less discretion afforded to you by financial markets that day than you will be comfortable with if your budget deficit has already gone on to be a fairly big number.[60]

Global economies

2.44 The committee discussed with RBA officials the economic performance of Australia's major trading partners and the implications for the domestic economy. In particular, the committee asked the Governor of the potential impacts the current political and economic events in Greece may have on the global and domestic economy. The Governor remarked on the potential for instability in the Euro area to affect the Australian market:

> It is a highly fluid situation over in Europe. If Greece were to leave the euro—I cannot believe that is actually in their interests, but if they did—then I think that would potentially be very disruptive for global markets because it would potentially raise again the whole question of the euro…
>
> The most likely outcome, I suspect, is that the Greeks and the European partners will find some way of keeping the show on the road for another year or two. The euro will carry on. They will have very low rates in Europe for a very long time. They will be doing so-called quantitative easing for some years. There will be spillovers of that around the world, which we may feel to a greater or lesser extent, just like there are spillovers when other countries do it. That is probably the good scenario, really.[61]

60 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 9.

61 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 19.

2.45 In relation to the Asia-pacific economy, the Governor commented that 'Chinese steel production has slowed notably'[62] and contributed to the decreasing price of iron ore. He added that this was an important metric for Australia that will be monitored closely in the future.[63]

2.46 Further to this, Dr Kent added that current forecasts estimate the price of iron ore will remain mostly unchanged in the near term.[64] He commented on the difficulty in predicting the impact that the high-cost supply of iron ore will have on price levels in future:

> In China, many of the producers are producing iron ore, it seems, at a cost that is above the current price. They are losing money, as best as most people can tell… That is the thing: we sit down and try and work out what the cost of production is, and the price cannot go below that for too long—otherwise, the production stops and then the price corrects back up. I think the surprising thing is how long some of the high-cost producers are holding on and losing money, and it is not clear how long they will continue to hold on for.[65]

2.47 The Governor responded to concerns arising from recent reports suggesting that China is facing increasing deflationary pressures, stating:

> …it does not seem to me all that likely that the kind of deflation that is really, really dangerous will take place in China…
>
> So, even if they got a bit of price deflation, it does not strike me as likely that that would get to be the intractable, ongoing, persistent deflation that has been so difficult for Japan to escape from. I do not think that that is that likely.[66]

2.48 In relation to the US economy, the committee noted recent predictions of a potential increase in interest rates by the US Federal Reserve around the 3rd quarter, and was interested in the effect such an outcome would have on the domestic economy. The Governor responded that in his view, the implications for the Australian economy should be welcomed:

> If the Fed get to the point, as it seems they will, where they feel that the US economy now warrants incremental rises in the Fed funds rate from zero to positive but still pretty low rates, we

62 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 5.

63 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 5.

64 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, pp. 21-22.

65 Dr Christopher Kent, Assistant Governor of the RBA, *Transcript,* 13 February 2015, p. 22.

66 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 22.

> should welcome that. It is a good sign if they think that the US economy is in that position.[67]

2.49 The committee also asked the Governor whether the increase in the number of countries turning to quantitative easing could potentially have a negative impact on the Australian economy. He responded:

> I would have to admit it is not reassuring, in some broad sense, that more countries feel they are in this position… it is a mark of the difficulties that the advanced countries, in particular, have faced in the aftermath of the financial crisis. I do not think that we will end up in that position. Nobody can be 100 per cent sure of these things, obviously… But for things to be so weak that the central bank is buying government debt as a last resort mechanism to try to impart stimulus to the economy is not a pretty picture. I do not think we will reach that point and I certainly would very much hope not to.[68]

Small business

2.50 The committee asked RBA officials for their views on measures to drive future growth of small businesses. Dr Lowe noted a number of options that could be considered by the government to encourage innovation and the expansion of small business. These included utilising recent advances in technology, tax incentives, funding mechanisms to provide venture capital for start-up businesses and through the innovation of Australia's exports.[69]

2.51 In relation to Australia's exports, Dr Lowe added:

> I see a possibility for us of being able to build on the natural advantages that we have to become innovative in a whole range of services in particular and in some specialised parts of manufacturing. But I think it needs a concerted effort to build a culture right across these various elements that I just mentioned. But how you actually do that, a central bank is not the expert in that.[70]

2.52 The committee queried the Governor on the availability of credit to small business. He noted that in the current market, credit was reasonably

67 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 7.

68 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 7.

69 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript,* 13 February 2015, p. 14.

70 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript,* 13 February 2015, p. 14.

available to small businesses although not under the same conditions that were offered in the past:

> The banks do want to lend more to small business. They will not do it at the sort of terms they did in 2006. The risk spreads are wider now. But I think that is the reality of the world that we live in. Nonetheless, the overall costs of loans to small business are as low as they have been in a very, very long time, and the banks do want to lend.[71]

2.53 The committee drew attention to the Basel Committee's recent report suggesting capital requirements be increased for Authorised Deposit-Taking Institutions (ADIs) using their own internal models to determine risk weights for credit exposures. The Governor explained that these changes may result in the major banks being less competitive in the residential property lending market, while the competitive position of smaller banks and non-bank players will generally remain unchanged:

> … if the idea is about risk weights on mortgage products in the banks that use the very low risk weights at the moment because they have the internal ratings set up, the Murray inquiry [Financial System Inquiry] said that perhaps those weights should be raised closer to the weights used by smaller banks, who do not have the fancy internal models. If that happens… then the major banks would have to have a bit more capital against those particular mortgages. That would raise the rate at the margin they need to charge the customer in order to get the rate of return on capital. But it will not affect the position of the other players, so it would make the majors slightly less competitive in that space, all other things being equal.[72]

2.54 The committee also asked whether banks are being particularly conservative in small business lending, and whether the higher cost of finance to small businesses was reducing their capacity to compete with major businesses in the market. He stated:

> … I think it is a fact that many small businesses are riskier than some of those larger businesses; and, I am sorry, but that means you have to pay more for finance. That is because risk and return have to go together. I do not see a way around that, not while it is left to market pricing.[73]

71 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 10.

72 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 21.

73 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 13 February 2015, p. 18.

Conclusion

2.55 The RBA board's forecasts in the February 2015 Statement suggest a slightly weaker outlook for GDP growth in the near term, which is reflected in subdued labour conditions and predictions that unemployment trends will rise slightly further and peak later than previously anticipated. The cash rate was lowered by 25 basis points to 2.25 per cent in February to provide support to demand, and is expected to boost GDP growth to above trend later in the forecast period. The committee noted that the growth of Australia's major trading partners was around its long run average in 2014 and is expected to continue at around its average pace in the near term.

2.56 The exchange rate has decreased recently, and is expected to adjust further to Australia's changing circumstances. However, there are positive indicators of GDP growth picking up to an above-trend pace in the latter part of the forecast period. The Government and the RBA must continue to adopt policies that will increase future growth, particularly in the non-resources sectors, and will enhance Australia's trade relationships with the Asia-pacific region. The Government must also look at policy options to address the decreasing levels of access to residential home ownership, particularly for first home buyers.

John Alexander OAM MP
Chair
18 March 2015

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Friday, 13 February 2015 – Sydney

Reserve Bank of Australia

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

Private briefing

Wednesday, 11 February 2015 – Canberra

Mr Rory Robertson, Analyst, Westpac Group Treasury

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.