

Monetary policy and other issues

Overview

2.1 On 1 August 2017, the Reserve Bank of Australia (RBA) decided to leave official interest rates unchanged at 1.50 per cent. The cash rate has remained unchanged since the committee's last hearing with the RBA in February. The most recent movement in official interest rates was the RBA's reduction of the cash rate by 25 basis points on 4 August 2016.

2.2 In his 1 August 2017 Statement on the decision, the Governor noted that the current circumstances called for monetary policy to remain accommodative. The Governor commented:

The low level of interest rates is continuing to support the Australian economy. Taking account of the available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time.¹

2.3 The RBA noted that conditions in the global economy have improved recently and that 'above-trend growth is expected in a number of advanced economies, although uncertainties remain.'²

2.4 The Governor remarked in his opening statement to the committee that:

Since we last met, the global economy has strengthened. As a result, in most advanced economies economic growth has been sufficient to generate lower unemployment rates. In fact, in a

1 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, *Media Release No. 2017-15*, 1 August 2017.

2 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, *Media Release No. 2017-15*, 1 August 2017.

number of countries unemployment rates are close to or below conventional estimates of full employment. Conditions have also improved in many emerging market economies partly due to increasing global trade, and commodity prices have mostly increased over the past few months as well.³

- 2.5 The RBA expects domestic economic conditions to improve as the global economy strengthens, with GDP growth forecast to rise above two per cent in late 2017, to 2³/₄–3³/₄ per cent over the year to December 2018.⁴
- 2.6 Underlying inflation is higher than late last year, and is expected to reach around two per cent over the second half of 2017. Headline inflation is expected to lie between two and three per cent over the year to December 2019.⁵
- 2.7 The Governor also noted the recent appreciation of the Australian dollar, which is expected to ‘contribute to subdued price pressures in the economy.’⁶ The Governor added that ‘an appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation than currently forecast.’⁷
- 2.8 The Governor remarked in his opening statement that strong growth in business investment is taking longer to occur than expected, however the Governor does see some improvements in parts of the economy:
- We are expecting a gradual pick-up in business investment outside the resources sector... in recent surveys, firms are reporting business conditions to be the strongest they've been in a decade, and over recent months firms have been prepared to hire quite a lot of workers as well. Our hope is that this improvement in conditions will eventually lead firms to overcome the reluctance that they've shown to commit to capital spending.⁸
- 2.9 In relation to the labour market, the RBA reported employment growth across all states. It noted that wage growth is expected to remain subdued, ‘but to increase gradually over the forecast period as labour market conditions continue to improve.’⁹

3 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 1.

4 RBA, *Statement on Monetary Policy*, August 2017, p. 61.

5 RBA, *Statement on Monetary Policy*, August 2017, p. 1.

6 RBA, Statement by Philip Lowe, Governor: Monetary Policy Decision, *Media Release No. 2017-15*, 1 August 2017.

7 RBA, Statement by Philip Lowe, Governor: Monetary Policy Decision, *Media Release No. 2017-15*, 1 August 2017.

8 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 4.

9 RBA, *Statement on Monetary Policy*, August 2017, p. 2.

- 2.10 During the hearing, the committee questioned the RBA on recent allegations made by the Australian Transaction Reports and Analysis Centre (AUSTRAC) against the Commonwealth Bank of Australia (CBA). While the Governor declined to comment on the specific allegations, areas of discussion included bank culture, accountability, and financial stability in the banking sector.
- 2.11 The Governor also responded to questions regarding the implications of climate change and the Paris Climate Agreement on the Australian economy, and recent increases in energy prices.
- 2.12 The Governor provided an update to the committee on the external review into the efficiency of the bank's operations, and responded to questions about the Board's discussion of a neutral cash rate at its July Meeting.

Forecasts

- 2.13 In its August 2017 *Statement on Monetary Policy*, the RBA reported that Australia's GDP growth is expected to pick up over 2017 to 2–3 per cent, and continue to grow to 2¾–3¾ per cent over the year to December 2018 (see Table 1).¹⁰

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

	Year-ended					
	Jun 2017	Dec 2017	Jun 2018	Dec 2018	Jun 2019	Dec 2019
GDP growth	1¾	2–3	2½–3½	2¾–3¾	3–4	3–4
Unemployment rate	5.6	5–6	5–6	5–6	5–6	5–6
CPI inflation	1.9	1½–2½	1¾–2¾	1¾–2¾	2–3	2–3
Underlying inflation	1¾	1½–2½	1½–2½	1½–2½	2–3	2–3
	Year-average					
	2016/17	2017	2017/18	2018	2018/19	2019
GDP growth	2	1¾–2¾	2¼–3¼	2½–3½	2¾–3¾	2¾–3¾

Source Reserve Bank of Australia, *Statement on Monetary Policy*, August 2017, Table 6.1, p. 61.
(a) Technical assumptions include A\$ at US\$0.80, TWI at 67 and Brent crude oil price at US\$53 per barrel.

- 2.14 The RBA's forecasts for growth in Australia's major trading partners remains little changed from the May Statement, and is expected to 'ease over 2018 and 2019.'¹¹

10 RBA, *Statement on Monetary Policy*, August 2017, p. 61

11 RBA, *Statement on Monetary Policy*, August 2017, p. 59

- 2.15 The RBA noted that the most recent domestic GDP data from the March Quarter showed growth that was a bit weaker than expected, which ‘partly reflected temporary factors, including weather-related disruptions to productions and some quarter-to-quarter volatility in resource exports.’¹²
- 2.16 The RBA expects domestic economic conditions to improve, with GDP growth forecast to rise above two per cent in late 2017, and to between three and four per cent by December 2019. The Governor explained:
- The transition to lower levels of mining investment following the mining investment boom is now almost complete, and this means that falling levels of mining investment will not be a drag on the economy for much longer now. Instead, with some large LNG projects reaching completion soon, GDP growth is expected to be boosted by a lift in LNG exports.¹³
- 2.17 The committee questioned the RBA on factors contributing to the GDP growth forecast rising to three percent. Assistant Governor, Dr Luci Ellis, said that in addition to accommodative monetary policy and an increase in LNG exports, the recovery in the labour market has contributed to the GDP growth forecast:
- The other thing that is already in the data is that we went through a soft patch in the labour force last year. The story of 2017 so far is that that has really turned around. Employment growth, and particularly full-time employment growth, has picked up. So, as we put together the forecasts, one of the things that are informing that is the sense that if you have more people in jobs, and more people in full-time jobs, they have higher incomes. That's going to boost income, and that should, all else equal, boost consumption.¹⁴

The cash rate and monetary policy

- 2.18 At its meeting on 1 August 2017, the RBA decided to keep interest rates unchanged at 1.50 per cent, noting that:
- Since August last year, the Board has held the cash rate steady at 1.5 per cent to provide the appropriate support for the economy in an environment of low inflation. The Board has sought to do this while balancing the risks associated with rising household

12 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

13 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

14 Dr Luci Ellis, Assistant Governor of the RBA, *Economic, Transcript*, 11 August 2017, p. 20.

indebtedness. The recent data are consistent with a gradual increase in inflation and a decline in the unemployment rate. Accordingly, at its recent meetings the Board has judged that holding the state of policy unchanged would be consistent with sustainable growth in the economy and achieving the medium-term inflation target.¹⁵

- 2.19 In his opening statement, the Governor explained the RBA's decision to hold the cash rate steady at 1.50 per cent:

This setting of monetary policy is supporting employment growth and a return of inflation to around its average rate over the past couple of decades. The board is seeking to do this in a way that does not add to the medium-term balance sheet risks facing the economy. It has been conscious that a balance needs to be struck between the benefits of monetary stimulus and the medium-term risks associated with rising levels of debt to our incomes. As a result, the board has been prepared to be patient. The fact that the unemployment rate has been broadly steady has allowed us this patience. We preferred a prudent approach, which is most likely to promote both macroeconomic and financial stability consistent with achieving the medium-term inflation target.¹⁶

- 2.20 The committee asked whether interest rates are likely to rise in the future. The Governor responded that 'the next rate move will be up rather than down – but it will not be for some time.'¹⁷ However, the Governor noted:

There are scenarios, of course, where rates could move down and there are scenarios where we could stay here for a long period of time – and, obviously, scenarios where we could go up. It's more likely that the next move will be up rather than down, but it's quite some time away if things play out as we expect. Inflation's going to be below two and a half per cent for quite a while. The unemployment rate is still a bit high.¹⁸

- 2.21 The committee asked the Governor whether central banks need to exercise caution in raising interest rates due to the potentially negative impact it could have on households. The Governor responded that the RBA would do its best 'to take account of the distribution of debt and how households are responding to higher interest rates.'¹⁹

15 RBA, *Statement on Monetary Policy*, August 2017, p. 3.

16 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 3.

17 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 5.

18 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 5.

19 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 11.

- 2.22 In its August 2017 *Statement on Monetary Policy*, the RBA outlined general trends in the exchange rate since the previous Statement. It noted that the Australian dollar has appreciated since the start of the year and has risen to late-2014 levels on a trade-weighted basis. The RBA added:
- Part of that reflects that broad-based depreciation of the US dollar and that fact that the RMB, which has a large weight in the Australian dollar trade-weighted index, has moved more closely with the US dollar than have many other currencies this year.²⁰
- 2.23 When asked whether he had concerns about the current value of the Australian dollar, the Governor remarked that 'a lower currency at the moment would be more helpful' and 'would help us get back to the desired inflation rate more quickly and the desired unemployment rate more quickly.'²¹
- 2.24 The committee questioned the Governor on whether the RBA would be likely to undertake foreign exchange intervention to reduce the current exchange rate. The Governor noted that 'there are scenarios in which we would be prepared to intervene in the foreign exchange market, but they're pretty remote scenarios. I don't feel like we're close to any of those at the moment.'²²

Business and the labour market

Business investment and corporate taxation

- 2.25 In his opening statement, the Governor remarked:
- For some time, we've been looking for a strong pick-up in private business investment outside the resources sector. This is taking longer to occur than we had expected. While we do see positive signs in parts of the economy, many firms still show some reluctance to commit to significant investment, often citing a range of uncertainties. It's possible that this reluctance will continue for a while yet, but it's also possible that the improvement in business conditions that we've seen will give firms the confidence to invest more after a period of underinvestment.²³
- 2.26 The Governor was asked whether there is an expectation of business investment growth given the current high levels of business confidence.
-

20 RBA, *Statement on Monetary Policy*, August 2017, p. 25.

21 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 18.

22 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 5.

23 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

The Governor noted the recent improvement in business conditions, and hopes that this 'will eventually lead firms to overcome the reluctance that they've shown to commit to capital spending.'²⁴

2.27 The Governor further explained:

We need stronger investment. That's really been the thing that we've been lacking for quite a while. So things that improve the investment climate are really important. The tax situation, obviously, is one thing that affects people's decisions to invest, but there are a lot of other things as well, and it's really resolving the uncertainties that people feel. I feel that's the main thing that's been holding back business investment – it's a general sense of uncertainty rather than the tax regime.²⁵

Labour market

2.28 According to the RBA August 2017 *Statement on Monetary Policy*, there was a pronounced pick-up in employment growth recorded in the June Quarter, which was 'driven entirely by full-time employment.'²⁶

2.29 The Governor remarked that employment growth has been noticeably stronger in recent months across all states, including in Western Australia and Queensland, which have been adjusting to lower levels of mining investment.²⁷

2.30 In its August Statement, the RBA reported that wage growth is 'expected to remain subdued, but to increase gradually over the forecast period as labour market conditions continue to improve.'²⁸

2.31 In his opening statement, the Governor noted that slow wage growth is occurring elsewhere in the global economy:

The reasons for the slow growth in wages are complex. The fact that it's a common experience across countries suggests that some global factors are at work. One possibility is that workers feel a heightened sense of potential competition, either from advances in technology or from international competition. More competition means less opportunity to put your price up. In the case of workers, it means lower rates of increase in wages. At the same time, many workers feel an increased sense of uncertainty, and

24 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 4.

25 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 15.

26 RBA, *Statement of Monetary Policy*, August 2017, p. 38.

27 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

28 RBA, *Statement on Monetary Policy*, August 2017, p. 2.

many feel less secure. This, too, is contributing to slow aggregate wages growth.²⁹

2.32 When asked if underemployment is a factor contributing to slow wage growth, the Governor said that while underemployment is putting some 'downward pressure on wages', global factors are having a bigger contribution to slow wage growth.³⁰ The Governor noted that this is why he has 'focused on competitive forces coming from technology and from globalisation, and the uncertainty that workers feel.'³¹

2.33 The committee questioned the Governor on whether the reduced role of unions in the labour market was contributing to slow wage growth. While the Governor noted that it was plausible that this had an influence, he stated that it was 'more likely that the primary influences are technology and globalisation because whenever we feel like there are more competitors out there we're less likely to put our price up.'³²

2.34 When asked about recent wage growth in unionised areas of the Australian workforce, such as the construction industry, the Governor remarked:

Those workers are getting higher wage increases because there's strong demand for their skills. It's not because there's a union getting these wage increases for them. It's basically the supply and demand factors in the labour market that are driving the bigger wage increases that we've seen.³³

2.35 Overall, the Governor remained optimistic that wage growth will pick up. While the Governor noted that we are going through a 'difficult adjustment period',³⁴ he remarked:

It can be quite protracted, but my expectation is that the basic laws of supply and demand will work out here. If we can have a steady expansion, both here and in the advanced economies, the strengthening of the labour markets will eventually lead to wage growth picking up, and people will start feeling a bit better again.³⁵

2.36 When asked to comment on public debates about income distribution, the Governor responded that 'there's a strong public interest in the inequality

29 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

30 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 8.

31 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 8.

32 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 8.

33 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 8.

34 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 21.

35 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 21.

debate.³⁶ The Governor also remarked that ‘one of the things that Australia's done fairly well is to, through the tax and transfer system, try to level out consumption inequality relative to income inequality.’³⁷

2.37 The committee noted the August 2017 release of the Household, Income and Labour Dynamics in Australia (HILDA) Survey.

2.38 Assistant Governor, Dr Luci Ellis, said ‘the general trend in those figures has been that fewer households in the HILDA survey are reporting that they're experiencing...vulnerability.’³⁸ Dr Ellis remarked:

There are still people who experience that, and obviously absolute poverty is something that stays more or less the same, whereas we also need to be mindful of relative disadvantage as income standards rise. But, based on what I've seen from the measures of household distress over the last 10 to 15 years, which is the life of the HILDA survey, you do tend to see that come down.³⁹

2.39 The Governor concluded:

The general point here is that Australia's done a pretty good job at addressing poverty issues. We haven't done a perfect job, but we've done a pretty good job relative to many other countries. The statistics you're quoting kind of reflect that.

...

[Inequality is] a legitimate issue, people are rightly worried about it, but on many measures we're doing better than some other countries.⁴⁰

Trends in the global economy

2.40 The committee questioned the Governor on trends in the global economy, including the performance of Australia's major trading partners, the bond market, uncertainties surrounding market confidence in the United States, and the Chinese economy.

2.41 The Governor remarked in his opening statement:

Since we last met, the global economy has strengthened. As a result, in most advanced economies economic growth has been

36 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 10.

37 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 10.

38 Dr Luci Ellis, Assistant Governor, *Transcript*, 11 August 2017, p. 10.

39 Dr Luci Ellis, Assistant Governor, *Transcript*, 11 August 2017, p. 10.

40 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 10.

sufficient to generate lower unemployment rates. In fact, in a number of countries unemployment rates are close to or below conventional estimates of full employment. Conditions have also improved in many emerging market economies partly due to increasing global trade, and commodity prices have mostly increased over the past few months as well.⁴¹

2.42 While the Governor noted the rise in economic growth in China and the Euro area, 'in the United States the earlier optimism that the new administration's fiscal policies would spur stronger growth seems to have dissipated a bit.'⁴²

2.43 In his opening statement, the Governor noted that the main challenge in China 'continues to be containing the risks from the build-up in debt while at the same time keeping the economy on a steady growth path.'⁴³

2.44 The Deputy Governor, Dr Guy Debelle, was asked whether the RBA was concerned that the Chinese government would not be able to contain the growth in credit in the Chinese market. The Deputy Governor explained that every country that has gone through a period of financial deregulation has had consequences that were difficult to manage:

It's pretty much the case that no country has gone through a period of financial deregulation and come through it with completely smooth sailing. Maybe China will be the first, or maybe not, and that remains to be seen. One thing that is worth noting, which we highlighted, is that they have been tightening up over the last while on aspects of the financial system. To date that hasn't had an effect on the overall macro economy there, but it doesn't mean that it won't eventually. We are still seeing debt levels continuing to rise. Will that eventually come unstuck, I think, is really the open question. It is one we're paying a lot of attention to, and it is a material risk out there for both the Chinese economy and the rest of the world.⁴⁴

2.45 The Deputy Governor further noted that most of China's debt is in 'domestic currency, primarily, and it's mostly held within China, which is quite different from a lot of other countries you have seen in the past.'⁴⁵

2.46 In responding to a question about ongoing concern about the trajectory of the value of the Australian Dollar, the Governor said:

41 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 1.

42 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 1.

43 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 1.

44 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 26.

45 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 26

... for some years what I'd been hoping would happen was that the US economy would strengthen; the Fed [Federal Reserve Bank] would raise interest rates; the US dollar would appreciate; the Australian dollar would depreciate in relative terms; that would help generate more employment growth here and push the inflation rate up; and then we would be able to commute our interest rates back to normal. That was one of the kinds of underlying assumptions we'd had about how things might develop. Well, the US economy did improve. The Fed eventually did raise rates – it took a while, but it eventually raised rates – and the US dollar, at least recently, has gone the other way. So it's an issue.⁴⁶

2.47 The Governor added:

One hypothesis for the weakness of the US dollar in recent times is that people have got disillusioned with the economic program of President Trump. When he was first elected, there was a hope of fiscal expansion, deregulation, more infrastructure spending and lower corporate tax rates, and that would lift inflation and spur growth in the US economy, and everything would be well with the world again. There were people who thought that, and the US dollar went up and US bond yields went up in response to that. As time has gone by, those things look less likely – still possible, but less likely – and the markets have got a bit disillusioned.⁴⁷

2.48 However, in response to questions regarding the difference in the falling currency markets compared to the rising equity markets in the United States, the Deputy Governor remarked that 'markets saying different things at the same time is a standard feature of markets.'⁴⁸ The Deputy Governor provided the following example from the beginning of the financial crisis:

Let me take you back then: the US equity market was at all-time highs, and, over the rest of the year 10 years ago, kept on going up. The bond markets and the credit markets started to think that things were going to get bad – correctly, as it turned out. So the equity market was happily trading high and went higher still for another six months or so before it turned around, even as credit markets were heading south. This does happen, that you get conflicting signals, and I suppose part of the thing is trying to

46 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 17.

47 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 25.

48 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 26

distil all the information you're getting there. I think one thing that is clear, in answering your question, is that the expectation of what was going to be delivered by the administration, as Phil [the Governor] mentioned, in terms of infrastructure spending and tax cuts – there is much less certainty that that is going to be delivered. I think it's fairly clear why that has been less reflected in the equity market than in the other markets we were talking about. I don't think anyone has a particularly coherent explanation for that.⁴⁹

2.49 In response to a question regarding the current state of the bond market, the Deputy Governor reported that yields have recently come down, and that borrowing rates for businesses 'are pretty much as low as they've been in a few decades.'⁵⁰

2.50 The Deputy Governor was asked about the next stage of Quantitative Easing (QE) in the global economy. The Deputy Governor remarked that the United States Federal Reserve will soon start to 'unwind their bond holdings by just letting them roll off, not by selling them.'⁵¹

2.51 When asked if this will be a risk to bond prices, the Deputy Governor responded:

The market is very much aware of it and, at least as of this morning, seems to be completely relaxed about it. Whether that stays the same going forward, when it actually starts happening, whether that dynamic persists, we'll just have to wait and see.⁵²

The household sector

2.52 In the August 2017 *Statement on Monetary Policy*, the RBA noted that household debt is likely to remain elevated for some time, adding that 'household credit growth overall has been steady over the past six months, but has continued to outpace income growth.'⁵³

2.53 The RBA reported that the recent growth in employment is supporting growth in household consumption, however, slow wage growth in conjunction with elevated levels of household debt could 'offset the forces supporting stronger consumption growth.'⁵⁴

49 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 26

50 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 11.

51 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 11.

52 Dr Guy Debelle, Deputy Governor of the RBA, *Transcript*, 11 August 2017, p. 11.

53 RBA, *Statement on Monetary Policy*, August 2017, p. 3.

54 RBA, *Statement on Monetary Policy*, August 2017, p. 3.

2.54 When asked if the RBA was concerned with the current levels of household debt and the effect rising interest rates may have on households in Australia, the Governor responded:

When you have more debt and interest rates go up it will crimp your spending. But we will be studying the effects very carefully. We're cognizant of the fact that household debt is higher and the interest sensitivity of spending on the way up could be higher as well. So we're doing what we can to understand the distribution of debt and how higher interest rates would affect people's spending patterns. We'll take that into account in our decisions.⁵⁵

2.55 In his opening statement, the Governor stated:

Another factor that has a bearing on the outlook is the behaviour of households. There's an adjustment of sorts going on, with many people getting used to lower growth in their real wages. Many now see this as more than just a temporary development, with wage increases of two point something per cent now the norm. In my view, the underlying drivers of the slower wage growth in Australia are much the same as we are seeing overseas. At the same time this is occurring, the household sector is also dealing with higher levels of debt relative to its income. Higher electricity prices are also affecting household budgets. This all means that consumer spending behaviour is something that we continue to watch very carefully.⁵⁶

2.56 When asked about the Australian Prudential Regulation Authority's (APRA) restrictions on investor lending, the Governor said he was 'pretty happy with how well it has played out.'⁵⁷

2.57 In relation to interest-only lending, the Governor thought it was appropriate that APRA curbed this lending practice, noting that he 'long thought it was problematic that in Australia sometimes more than 40 per cent of housing loans did not require the repayment of one dollar of principal on a regular basis.'⁵⁸

2.58 When asked to comment on the rising cost of living, the Governor noted that the current rate of increase in the consumer price index is 1.9 per cent over the past year. While noting the large increase in prices for electricity, health care and child care, the Governor stated that 'a lot of the prices in

55 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 9.

56 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 2.

57 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 6.

58 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 6.

the CPI are quite weak.⁵⁹ The Governor noted that food price inflation in Australia for the last seven years has been below two per cent, and that the price of clothing and household items has declined in the last year.⁶⁰

2.59 The Governor added:

It's not as if prices are rising quickly in the average bundle of goods that people are buying. That's just not the case. The issue is really on the income side. It's the lack of wage growth and income growth that's the issue, not the fact that the cost people are paying are rising at an unusually rapid rate. We're really back to the income side.⁶¹

2.60 When asked about household saving rates, Dr Luci Ellis, Assistant Governor, responded:

I think another way of thinking about this would simply be that we had a period where there were a lot of people working in an industry that they knew they weren't going to work in forever. People who went to work on mining investment projects didn't expect to be doing that for their whole lives, and they were earning wages that were significantly above what they could earn in other industries. Consequently, they actually did save a lot of that... It's people making decisions about their lives and saying, 'I'm going to go and work in the mines for a while, and I'll earn more than I would otherwise, but it's not going to be forever, so I'll save more of it.' That's exactly what the permanent income hypothesis says. So the state pattern of household saving ratios does actually align with that.⁶²

2.61 The Governor added that the saving rate has come down partly as 'people have been trying to sustain the level of consumption growth in an environment of weaker income growth.'⁶³

2.62 According to the RBA, housing markets across Australia have been mixed, with conditions in Sydney and Melbourne remaining strong, house prices in Perth 'have declined a little further', while growth in apartment prices in Brisbane have been weak.⁶⁴

59 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 12.

60 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 12.

61 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 12.

62 Dr Luci Ellis, Assistant Governor of the RBA, *Economic, Transcript*, 11 August 2017, p. 14.

63 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 14.

64 RBA, *Statement on Monetary Policy*, August 2017, p. 3.

- 2.63 The Governor noted that one positive development ‘coming over the next year is the big increase in supply. The next year, the addition to the number of dwellings in the country is set to be a record high.’⁶⁵
- 2.64 The Governor reported that rental growth in Australia ‘is less than one per cent, so that’s the lowest in quite a few decades for the country as a whole.’⁶⁶ The Governor remarked:
- In Western Australia, rents have fallen a long way. In parts of Brisbane, particularly in the inner city, they’ve fallen as well. In Sydney and Melbourne, they’re probably rising at around three per cent on average, and in much of the rest of the country they’re flat.⁶⁷
- 2.65 The Governor added:
- The population’s rising quickly and for quite a few years we’ve underinvested in housing... I thought there’d be pressure on the housing stock and that that would push up rents, but that doesn’t seem to have been the case.⁶⁸

Other issues

AUSTRAC allegations against CBA

- 2.66 On 3 August 2017, AUSTRAC initiated civil penalty proceedings in the Federal Court against the CBA for non-compliance with the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act).⁶⁹
- 2.67 When asked to comment on the allegations made by AUSTRAC, the Governor noted that the matter is currently before the courts and made some general observations. The Governor remarked that ‘banks should not be doing money laundering, and they should know who is operating the accounts that they open. They’re very important laws and they need to be respected.’⁷⁰
- 2.68 The Governor outlined three foundations of bank culture – trust, service and risk management:

65 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 15.

66 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 15.

67 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 14.

68 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 15.

69 Federal Court of Australia, *Australian Transaction Reports & Analysis v Commonwealth Bank of Australia*, 7 August 2017, <<http://www.fedcourt.gov.au/services/access-to-files-and-transcripts/online-files/atr-v-cba>>, accessed 17 August 2017.

70 Dr Philip Lowe, Governor of the RBA, *Transcript*, 24 February 2017, p. 5.

On trust, I think it's fair to say that trust in banking has been strained. The banks know that, and it needs to be a priority to rebuild trust.

On service: I think it's fair to say that service has taken a back seat to sales. The banks know that and they are addressing it – changes in remuneration structures and incentives within the organisation. But I think there has been for too long a focus on sales and not on service.

The third element of a strong banking culture is risk management. By and large, the Australian banks have done okay here. Now, they didn't fall into the same trap that overseas banks did a decade or so ago and our system benefited from that. But I think we can all identify examples where the desire for short-term profit has probably led to not enough attention to risk management issues. So the focus needs to be on rebuilding trust and delivering high-quality service to customers, and a strong focus on risk management. Those are the things that we need to focus on.⁷¹

- 2.69 The Governor was asked whether personal responsibility for the senior executive teams running the banks is important to bank culture. The Governor stated that, in general, there needs to be accountability and someone held to account:

I am not going to opine on which particular individual needs to be held to account. But, in general, there needs to be accountability. That can be through the court process – that is one way our society does it – but in a well-run organisation there should be accountability within the organisation as well. We need to make sure that happens.⁷²

- 2.70 When questioned on the effect these allegations may have on the banking sector, the Governor stated that, 'from a financial stability perspective our main concerns is the resilience of the banks.'⁷³ While noting that conduct issues do impact the reputation of banks, the Governor remarked that the RBA's focus is 'really on making sure that the balance sheets and capital and all those sorts of things mean the banks are strong and resilient to shocks.'⁷⁴

- 2.71 The committee also asked the RBA if market concentration in the Australian banking sector had any financial stability risks or benefits.

71 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 6.

72 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 16.

73 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 7.

74 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 7.

Ms Michele Bullock, Assistant Governor, responded that it ‘could go either way’⁷⁵:

You could have large banks; and if something goes wrong in large banks, that might have knock-on effects and financial stability consequences. On the other hand you could say that, because they are large banks and they are well supervised and they are focused on doing their business well – they have good risk-management systems, as the governor already mentioned – those sorts of things mean there are financial stability benefits to the banks. The point I was trying to make is that the evidence in Australia suggests it has not really been one way or the other.⁷⁶

Climate change and energy markets

2.72 The committee questioned the RBA on whether it had considered the implications of climate change and the Paris Climate Agreement. The Governor noted that while these issues are ‘beyond the mandate of a central bank’,⁷⁷ they were discussed at the July RBA board meeting, particularly in the context of energy markets. The Governor commented:

It is pretty clear that climate change and adaptation could have broad effects on the economy – on output, trade, prices and investment... There is going to be investment uncertainty in electricity generation in particular but, more generally, there will be uncertainty about climate change and adaptation. Is that one of the factors that is delaying business investment in parts of the economy? We have had a substantial discussion of that. How does the potential export mix of Australia in the future look? I think the next couple of years are pretty clear. Beyond that, there are a range of scenarios. Of most direct concern to us is the price of electricity and the issues we were talking about before. That is having an impact on CPI now and will do so over the next year. It is affecting household spending decisions. It is flowing right through output and investment prices. Like everybody else, we are trying to understand that as best we can... But I can assure you we are taking these issues seriously and, to the extent that they are

75 Ms Michele Bullock, Assistant Governor of the RBA, Financial System, *Transcript*, 11 August 2017, p. 6.

76 Ms Michele Bullock, Assistant Governor of the RBA, Financial System, *Transcript*, 11 August 2017, p. 6.

77 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 23.

relevant to our mandate, we incorporate those into our discussions and decision making.⁷⁸

2.73 In its August 2017 *Statement on Monetary Policy*, the RBA noted the increase in energy prices:

Inflation in prices of utilities has picked up considerably in recent quarters. This is primarily due to a sharp rise in wholesale prices for gas and electricity in recent years, reflecting supply constraints following the closure of coal-powered electricity plants and a lack of industry investment widely attributed to uncertainty over electricity and environmental policies.⁷⁹

2.74 The Governor was asked whether uncertainty about the issue of a clean energy target is resulting in a lack of investment and higher electricity prices. The Governor responded:

There is uncertainty about the policy environment and that is delaying investment. That is not in dispute. The investment uncertainty is not just in electricity generation; it's affecting investment decisions in other parts of the economy, because businesses aren't sure about the future price of electricity, so it's another reason to wait... The higher prices of electricity are also affecting household budgets, particularly for lower income households, who spend a disproportionately high share of their income on electricity. It's crimping their budgets and having an effect on consumption, and it's going to have an effect on the CPI as well. So investment uncertainty, spending decisions and the CPI are the perspectives that we're looking at this from.⁸⁰

2.75 The Governor added that he did not disagree with the proposition that 'providing some certainty about the future structure of the electricity generation industry would be useful for the country, for investment, on prices and on household budgets.'⁸¹

Corporate governance

2.76 At the previous hearing, the Governor informed the committee that the RBA was conducting an efficiency review of its operations, 'to make sure

78 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 23.

79 RBA, *Statement on Monetary Policy*, August 2017, p. 56.

80 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 9.

81 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 9.

that we are continually improving as an organisation and we are seeking outside assistance to identify opportunities for improvement.⁸²

2.77 The Governor told the committee that the review had been completed, and discussed its findings:

It concluded that our support functions were functioning well, and they assisted the achievement of the bank's important public policy objectives. At the same time, though, it suggested some areas for us to focus on. One was the development of a shared internal services centre to drive continuous improvement within the bank. Another was further evolution of our approach to IT as some of our major IT related projects come to an end. These projects are in the banking and payments areas, and they've been undertaken in the national interest. As these projects wind down, we're looking to make sure that the size and structure of our IT function remain appropriate. And, more broadly, as some of these projects finish later this year, the bank's overall staff numbers will decline.⁸³

2.78 The Governor was asked about a discussion of the neutral cash rate outlined in the Minutes of the Monetary Policy Meeting on 4 July 2017.⁸⁴ In this meeting, the Board commented that the neutral interest rate was 'around 3½ per cent'.⁸⁵

2.79 The committee noted the market's reaction to the RBA's comments, which may have had a meaningful impact on the exchange rate. In reference to this market response, the committee asked whether the RBA intended for that to occur and, if not, if there were any lessons learned about the process of communication with the broader market. The Governor responded:

At the same time we did this, many central banks were starting to change their rhetoric. The Bank of Canada increased its interest rates, and the ECB may not be going to do quite as much expansion as before, and some of the Nordic central banks have changed their rhetoric as well. I think what happened was that the market incorrectly took the fact that this was in our minutes as a signal that we were about to join that club of changing our rhetoric. That was not our intention. It was to have an analytical

82 Dr Philip Lowe, Governor of the RBA, *Transcript*, 24 February 2017, p. 3.

83 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 3.

84 RBA, *Minutes of the Monetary Policy Meeting of the Reserve Bank of Australia*, 4 July 2017, <<http://rba.gov.au/monetary-policy/rba-board-minutes/2017/2017-07-04.html>>, accessed 17 August 2017.

85 RBA, *Minutes of the Monetary Policy Meeting of the Reserve Bank of Australia*, 4 July 2017.

discussion with the board about what the average interest rate is likely to be over time. We think that's an important discussion to have, and I think it's important for the community to understand that we're having those discussions and what our thinking is.⁸⁶

- 2.80 When further questioned on whether it would have been reasonable to clarify the context of the discussion when the minutes were issued, the Governor remarked that this route may have been reasonable. However, as the Deputy Governor was scheduled to give a speech later that week, the Governor stated that the Deputy Governor would have been able to provide context at that time:

I understand that there was some short-term reaction in markets. It would have been better if that hadn't occurred, but people now understand where we're coming from. I don't think it's had any lasting impact. There will be in our minutes periodic discussions of issues, and people shouldn't read too much into those. I hope now that that's widely understood. We might have been able to handle it better, but, in the end, I think it's okay that the community understands what we're doing.⁸⁷

- 2.81 The Governor added that the RBA takes their responsibility 'to explain those issues to the public very seriously', and are aware of the significant impact statements made by the RBA can carry.⁸⁸

Conclusion

- 2.82 Following a weaker than expected March quarter, Australia's economic growth is expected to pick up, supported by accommodative monetary policy and a lower exchange rate. Inflation is higher than last year, and is expected to reach around two per cent over the second half of 2017.
- 2.83 Since the start of 2017, around 165,000 full-time jobs have been created, average hours worked have increased, and labour force participation has risen. As a result, employment has increased in every state over this period, and unemployment has dropped to 5.6 per cent. The unemployment rate is forecast to be a little under 5½ per cent by the end of 2019.
- 2.84 Business investment is expected to increase gradually as growth in demand increase, although uncertainty remains about the timing of this

86 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 4.

87 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 5.

88 Dr Philip Lowe, Governor of the RBA, *Transcript*, 11 August 2017, p. 5.

increase. Many of the conditions that would usually be associated with stronger growth in business investment are in place, including low interest rates and tax cuts for small and medium businesses.

- 2.85 Overall, Australia's economic growth outlook is optimistic, with the transition to lower levels of mining investment almost complete. Increases in the production of LNG are expected to lead to GDP growth in Australia of between 2 and 3 per cent by the end of 2017.

Mr David Coleman MP

Chair

6 September 2017