The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2019 (First Report)

House of Representatives
Standing Committee on Economics

March 2020
Canberra

ISBN 978-1-76092-082-1 (Printed Version)
ISBN 978-1-76092-083-8 (HTML Version)

Chair's foreword

On 4 February 2020, the Reserve Bank of Australia (RBA) left official interest rates unchanged at 0.75 per cent. In making this decision, the Governor said the RBA judged that 'with interest rates having already been reduced to a very low level and recognising the long and variable lags in the transmission of monetary policy, the Board decided to hold the cash rate steady at this meeting.'

This decision by the RBA, and a range of other topics, were scrutinised at the committee's public hearing on 7 February 2020. The committee continued its work in providing public accountability and transparency of the operations of the RBA.

The RBA expects growth in the Australian economy to strengthen gradually, with the RBA's central scenario forecasting GDP growth of around 2.75 per cent over 2020 and 3 per cent over 2021. This outlook, the Governor commented, is being 'supported by accommodated monetary policy, a new expansion phase in the resources sector, stronger consumer spending and a recovery in dwelling investment later this year.'

Following on from global uncertainty caused by trade disputes between the United States and China, the phase one deal struck between these two powers has lessened tensions and the global economy has picked up again. This is expected to help drive growth in Australia with more certainty in export markets.

Inflation remains low in the Australian economy and underlying inflation has been below 2 per cent for around three years. CPI inflation was 1.8 per cent over 2019 and is forecast to lift gradually to around 2 per cent over the next year or so.

The labour market has continued its strong growth and the unemployment rate declined to 5.1 per cent in December 2019. The Governor stated that he expects this to fall to a little below 5 per cent as the economy grows. He noted that 'most of the forward-looking indicators, including job vacancies and hiring intentions, suggest there is going to be reasonable growth over the months ahead.'

The Governor explained that the labour force participation rate is the highest it has ever been, so even with strong job growth of an average of 2½ per cent, the unemployment rate has only come down slightly. The RBA noted that this means more Australians than ever before are in the workforce. As the economy grows, those workers seeking more hours should be able to take on more work, which will help address the issue of underemployment.

The impact of the drought, bushfires and COVID-19 coronavirus on the economy are expected to be significant in the coming months. The RBA has forecast a 0.2 per cent decline in GDP growth over the year due to the bushfires, a 0.25 per cent decline due to the drought and 0.2 due to the virus. The RBA advised the committee that the full impact of the coronavirus, in particular, is difficult to forecast as 'much will depend on the success of the various efforts to control the virus.'

Since the hearing the outbreak of COVID-19 has escalated. The risk it poses to the Australian economy is slowly being revealed, particularly for small and medium enterprises reliant on goods through supply chains and customers from China. Many SMEs face increasing risks to accessing stock for customers. It may take many months for supply chains to fill existing gaps and provide reliable supplies. Similarly, service-based businesses face increased risks from declining demand.

The consequences of the RBA's decision to lower interest rates in the second half of 2019 are now being realised. Money is already cheap and this leaves the RBA with limited flexibility to further reduce rates and adjust to unexpected shocks.

Since the hearing the RBA has reduced rates by a further 25 basis points to 0.50 per cent. While initial market reactions were positive and provided a degree of confidence, this is likely to be temporary. Reducing interest rates may build temporary confidence, but it is a solution to a misdiagnosed problem. The Australian economy does not face a problem of liquidity.

The temporary challenge the Australian economy faces relates to a crunch of supply in some sectors, and demand in others. In the short to medium term, COVID-19 will present serious challenges to SMEs in terms of meeting their financial obligations while maintaining employment levels. The banking sector faces a significant challenge to reassure customers and provide flexible financing options through a serious, but nonetheless temporary, event.

In light of the temporary nature of the challenge, and with a view towards retaining capacity to readjust amidst a recovery, the RBA should consider the efficacy of conditional longer-term funding options for retail banks. This would aim to enable SMEs to continue trading while the crisis is ongoing, thereby ensuring that SMEs are in the best position to maintain employment levels and lead a post-COVID-19 recovery. Doing so would also ensure the RBA does not continue tapping into the already 'empty well' of low rates.

The committee remains concerned about the impact of low interest rates on Australians who rely on interest-bearing products for income. The committee will continue to hold the RBA to account for the effects of interest rate decisions on all Australians and the Australian economy. The committee will also continue to closely examine the effects of the fires, drought and coronavirus as they develop.

On behalf of the committee, I thank the Governor of the Reserve Bank, Dr Philip Lowe, and other representatives of the RBA for appearing at the hearing on 7 February 2020. The next hearing will be on 14 August 2020.

Tim Wilson MP
Chair

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Membership of the Committee

Chair	Mr Tim Wilson MP
Deputy Chair	Hon Dr Andrew Leigh MP
Members	Dr Anne Aly MP
	Mrs Bridget Archer MP
	Mr Adam Bandt MP
	Mr Jason Falinski MP
	Mr Craig Kelly MP
	Mr Andrew Laming MP
	Dr Daniel Mulino MP
	Mr Ted O'Brien MP

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Ms Stephanie Woodbridge
Office Manager	Ms Jazmine Rakic

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.

Abbreviations

CPI	Consumer Price Index
GDP	Gross Domestic Product
QE	Quantitative Easing
RBA	Reserve Bank of Australia

1

Introduction

Background

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

1.2 The appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *Seventh Statement on the Conduct of Monetary Policy*, agreed between the then Treasurer, the Hon Scott Morrison MP, and the RBA Governor, Dr Philip Lowe. The statement formalises the biannual appearance before the committee and is reproduced at Appendix B. It 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.

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1 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016.

Scope and conduct of the review

1.4 The second public hearing of the committee with the RBA during the 46th Parliament was held in Canberra on 7 February 2020.

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 A list of the RBA representatives who appeared before the committee at the public hearing can be found at Appendix A.

1.7 Before the hearing, the committee received a private briefing from Dr Sally Auld, Chief Economist at JP Morgan. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Dr Auld's cooperation and assistance.

1.8 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and have assisted in providing a public face to parliamentary committees and the RBA. These hearings are also an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.9 This report focuses on matters raised at the public hearing and draws on issues raised in the RBA's February 2020 *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA's website.[3]

Further evidence sought

1.10 Following the hearing, the committee sought further clarification in writing from the RBA on a range of topics including:

- the impact of the coronavirus and drought on GPP growth of terms of trade
- the competing narratives about the Australian macroeconomy and how the RBA has sought to shape them
- the research undertaken by the RBA in regards to the effectiveness of lowering interest rates below current levels

2 House of Representatives Standing Committee on Economics, *Past Public Hearings and Transcripts*, 7 February 2020, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBAReview2019/Public_Hearings>, accessed 17 February 2020.

3 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020.

- how changes in monetary policy compare to changes in prudential controls in reduce risks posed by the over-expansion of credit, and
- the research undertaken by the RBA in regards to the possibility of an economic downturn and the size of its macroeconomic effects

1.11 The RBA's responses to questions in writing are available on the inquiry website.[4]

Next public hearing with the Reserve Bank of Australia

1.12 The committee will conduct the next public hearing with the RBA on 14 August 2020 in Canberra. More details will be circulated in the weeks leading up to the hearing.

4 House of Representatives Standing Committee on Economics, *Review of the RBA Annual Report 2019,*<https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBAReview2019/Documents>, accessed 28 February 2020.

2

Monetary policy and other issues

Overview

2.1 Since the Reserve Bank of Australia (RBA) appeared before the committee in August 2019, the RBA has eased monetary policy by 0.25 basis points to 0.75 per cent, following the RBA's decisions to cut the cash rate in October 2019. At its meeting on 4 February 2020, the RBA decided to leave the cash rate unchanged at 0.75 per cent. [1]

2.2 Commenting on the decision to keep rates on hold, the RBA Governor, Dr Philip Lowe said 'the outlook for the global economy remains reasonable.'[2] However, he advised there were elements of uncertainty at play:

> One continuing source of uncertainty, despite recent progress, is the trade and technology dispute between the US and China, which has affected international trade flows and investment. Another source of uncertainty is the coronavirus, which is having a significant effect on the Chinese economy at present. It is too early to determine how long-lasting the impact will be.[3]

2.3 The Governor reported that 'the central scenario is for the Australian economy to grow by around 2¾ per cent this year and 3 per cent next

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1 Reserve Bank of Australia (RBA), *Statement by Philip Lowe, Governor: Monetary Policy Decision*, Media Release No. 2020-01, 4 February 2020.

2 Reserve Bank of Australia (RBA), *Statement by Philip Lowe, Governor: Monetary Policy Decision*, Media Release No. 2020-01, 4 February 2020.

3 Reserve Bank of Australia (RBA), *Statement by Philip Lowe, Governor: Monetary Policy Decision*, Media Release No. 2020-01, 4 February 2020.

year' but that 'in the short term, the bushfires and the coronavirus outbreak will temporarily weigh on domestic growth.'[4]

2.4 On this outlook, the Governor said, 'progress is expected towards the inflation target and towards full employment, but that progress is expected to remain gradual.'[5]

2.5 The RBA's February Statement reported that inflation remains low and that 'the recent inflation data were in line with our expectations and confirmed a modest lift in CPI inflation over recent quarters to 1.8 per cent.'[6] The RBA forecasts that inflation will 'increase gradually to 2 per cent over the next couple of years.'[7] The RBA commented:

> The outlook for inflation in part rests on the expectation that the drag coming from housing related inflation will dissipate as the housing market recovers following the easing in monetary policy. Early signs of this are evident in reduced discounting of the prices of newly built houses in the December quarter. Retail price inflation has generally been subdued, but the drought has been putting upward pressure on the prices of an increasing range of food items.[8]

2.6 The committee questioned the Governor on the effectiveness of the RBA's monetary policy stance, in particular the justification for maintaining a low interest rate environment for the foreseeable future. The committee also scrutinised the Governor on the RBA's record in achieving its inflation target.

2.7 The committee questioned the Governor around the potential impact of the drought, bushfires and coronavirus on Australia's GDP. The committee also scrutinised the research base used in decision making by the RBA board and the efficacy of RBA forecasting.

4 Reserve Bank of Australia (RBA), *Statement by Philip Lowe, Governor: Monetary Policy Decision*, Media Release No. 2020-01, 4 February 2020.

5 Reserve Bank of Australia (RBA), *Statement by Philip Lowe, Governor: Monetary Policy Decision*, Media Release No. 2020-01, 4 February 2020.

6 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

7 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

8 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2-3.

The cash rate and monetary policy

2.8 On 4 February 2020, the RBA Board decided to leave the cash rate unchanged at 0.75 per cent, following its decision to lower the cash rate in October 2019. Commenting on the decision in his opening statement, the Governor said the RBA has 'taken account of the fact that interest rates have already been reduced to very low levels and that there are long and variable lags in the transmission of monetary policy.' The Governor explained that 'the board also recognises that a balance needs to be struck between the benefits of lower interest rates and the risks associated with having interest rates at very low levels.'[9]

2.9 When the committee last met with the RBA in August 2019, the Governor said 'there have been a number of developments that could be expected to support the Australian economy over the next couple of years' but that it is 'nevertheless, reasonable to expect an extended period of low interest rates in Australia. This reflects what's happening both here and overseas.'[10]

2.10 The Governor told the committee that the data the RBA has received since it last met with the committee continued to support this assessment, the Governor commented 'when we met six months ago I said there were signs that the Australian economy may have reached a gentle turning point. The data we have received since we last met is consistent with this.'[11]

2.11 The Governor said the RBA held the cash rate steady due to a number of factors and advised that 'lower interest rates could also encourage more borrowing by households eager to buy residential property at a time when housing debt is already quite high and there's already a strong upswing in housing prices in place.' He added that 'if so, this could increase the risk of problems down the track'.[12] He explained:

> After considering this balance at its recent meetings, the board has decided to maintain the cash rate steady at 0.75 per cent. We recognise though that the nature of the balance between the benefits of lower interest rates and the risks can change over time and that balance is very much dependent upon the state of the economy. If the unemployment rate were to be moving materially in the wrong direction and there was no further progress being

9 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 3.

10 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

11 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 3.

12 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 3.

> made towards the inflation target, the balance of the arguments would tilt towards a further easing of monetary policy. So we're continuing to watch the labour market carefully, as we seek to strike the right balance in the interests of the community as a whole.[13]

2.12 The Governor noted that there has been slow growth in household spending, despite prevailing low interest rates. He told the committee 'for some time now, households have been gradually adjusting their spending to slower growth in income.'[14] He explained that it appeared as though this adjustment period accelerated in 2019, with households scaling back their spending in the face of falling house prices and slow wage growth. However, he advised that he did not expect this trend to continue for an extended period. The Governor explained:

> As households become more comfortable with their finances they should have the confidence to spend more. Continued growth in employment, stronger growth in disposable income than in recent years and the recent increase in housing prices will also help, as will an upswing in the residential construction sector. So we are expecting stronger growth in consumption over the course of this year, although there is some uncertainty about how long this period of balance sheet adjustment we've been going through will last.[15]

2.13 The committee asked if current monetary policy was risking potential issues in the future, particularly in regards to individuals taking on too much debt, which could become difficult to pay down when interest rates eventually rise. The Governor advised that 'it is possible to have too much of a good thing.'[16] He commented:

> The issue we're grappling with is where is that point where it is removed from a situation where the lower interest rates have helped, which I think they have over the past year, to a situation where they're building up vulnerabilities for the future. Where is that crossover point? The truth is no-one really knows, and that's the issue we're grappling with.[17]

2.14 The Governor noted that many Australians have used the cut in interest rates to pay down existing debt. The RBA explained that mortgage

13 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 3.

14 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 2.

15 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 2.

16 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 5.

17 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 5.

payments have risen across the country while the data in the national account has shown that household interest payments have reduced markedly in the September quarter. It found that even when taking into account the low and middle income tax offset that many households would have received and put towards their mortgages, there was still an increase in mortgage payments. The RBA advised:

> …what we've actually seen in the September and December quarter, as shown in the graph in Phil's speech, was that total repayments have increased. So it's not just this passive thing of keeping your repayment at the same level; it's also that some people must've decided to make more, or they had some spare cash that they put into their offset accounts, which counts towards that figure and saves them interest along the way.[18]

2.15 The Governor commented that a range of factors seem to have contributed to this increase in debt repayments: the low and middle income tax offset, lower interest rates and low wage growth. He remarked 'it's all these things. It's the tax refunds. It's lower interest payments and the saving rate going up. They're all contributing.'[19]

Forecasts

2.16 In its February Statement, the RBA forecasts Australia's GDP growth to reach about 2¾ per cent over 2020. It is expected to pick up gradually to 3 per cent over 2021, and remain around 3 per cent over 2022, which is a little higher than previously forecast (see Table 1).[20]

18 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 6.

19 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 6.

20 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 72.

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

	Year-ended					
	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021	June 2022
GDP growth	2	2	2¾	3	3	3
Unemployment rate (b)	5.2	5¼	5	5	4¾	4¾
CPI inflation	1.8	1¾	1¾	1¾	2	2
Underlying inflation	1.6	1¾	1¾	1¾	2	2
	Year-average					
	2019	2019/20	2020	2020/21	2021	2021/22
GDP growth	1¾	2	2¼	2¾	3	3

Source Reserve Bank of Australia, Statement on Monetary Policy, February 2020, Table 5.1, p.72.
(a) Technical assumptions include the cash rate moving in line with market pricing, TWI at 58, A$ at US$0.67 and Brent crude oil price at US$54 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the November 2019 Statement on Monetary Policy

2.17 The committee asked the Governor what research base was being used to support forecasting, in light of missed targets in the last few years. The Governor noted 'we've looked at our forecasting record, and, over recent times, broadly it's no worse or no better than it has been in previous decades.'[21] He identified a range of factors impacting forecasting including the larger than expected decline in house values, the rise in labour force participation without a similar lowering of the unemployment rate and an unexpected decline in per capita consumption growth.[22]

2.18 The committee questioned the reliability of RBA forecasting and the confidence the Australian public can have in such forecasting, given targets are being missed. The Governor said that the RBA had not forecast the household balance sheet adjustment; a sharper decline in housing prices; or the rise in labour force participation. [23] This has resulted in the unemployment rate remaining static. The Governor said:

> We did not pick this rise in participation and we did not pick the extent of the household balance sheet adjustment. So they're the big forecast misses last year but, by and large, our forecasts recently have been no better or worse than average. We've got to be realistic: we don't have a crystal ball.[24]

21 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.
22 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8
23 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8
24 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.

Adequacy of the inflation target

2.19 The committee scrutinised the RBA's ability to meet its inflation target, as set out in the *Seventh Statement on the Conduct of Monetary Policy* (the Statement). In the Statement, the Governor and the then Treasurer, the Hon Scott Morrison MP, agreed that 'an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time.'[25] The Statement also noted that 'the 2 to 3 per cent medium-term goal provides a clearly identifiable performance benchmark over time.'[26]

2.20 The committee asked the Governor how the RBA could effectively meet the inflation target over the next few years. The governor advised that 'you'd have to have much lower interest rates to get inflation up. It's just not practical at the moment to get inflation back to 2½ per cent in two years time or 18 months time with monetary policy.' The Governor explained that this is an issue being faced around the world:

> This is why I've got this focus very much on the medium term—getting there gradually over time. We've got to be realistic about what can be achieved with our instrument in a world where the relationship between unemployment and inflation is much weaker than it once was. We're seeing this in every country around the world. There are countries with unemployment at its lowest in 40 or 50 years and inflation is still not picking up. So, something's changed in inflation dynamics around the world, and the same is true in Australia, and we can't really hide from that.[27]

2.21 The committee asked about the RBA's timeframe for reaching the inflation target of between 2 and 3 per cent. The Governor explained that the RBA did not have a specific deadline for reaching the target due to a range of external factors. He remarked:

> …given the structural factors that are changing the world economy and some of the domestic issues, I don't have a crystal ball. All I can tell you is that we will not be raising interest rates until we are confident that inflation will be back within the two to three per cent range. I would like that to be sooner rather than later.[28]

25 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016, p. 3.

26 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016, p. 3.

27 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.

28 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 7.

2.22 Given these circumstances, the committee asked if the RBA should be revising its targets. The Governor replied 'the discussion that's taking place internationally at the moment in many policy circles is actually that inflation targets should be raised, not lowered.'[29] He went on to explain:

> …the logic here is that if you have a low inflation target you then have a low average level of interest rates, and if interest rates are low on average there's a greater probability that you'll hit the zero or effective lower bound. If you have a higher inflation target, you have higher average interest rates and therefore a lower probability that you'll hit the zero or lower bound. I think that's the discussion that's taking place, and I think that's a reasonable perspective. I'm not advocating for lifting our inflation target, but not many people are thinking of lowering inflation targets. I think it would be inappropriate to lower our target just so that we could say we met it.[30]

Effects of low interest rates on consumer confidence and the income of depositors

2.23 The committee asked if the RBA meeting minutes from November 2019 accurately portrayed any shift in consumer confidence as a consequence of lowering interest rates. The Governor agreed that 'the minutes did record that we had a discussion on this'.[31] The minutes read that the RBA 'recognised the negative effect of lower interest rates on savers and confidence.'[32] The Governor stated 'I don't accept the idea that this is what is driving weak confidence.' [33] However he acknowledged that 'it is the case that there are many, particularly older Australians who, when we cut interest rates, have a reasonable reduction in their interest income, and their confidence is damaged and they feel bad and they don't spend as much.'[34] The Governor went on to explain:

> The discussion was really in the context of: there is a group of people; when we cut interest rates, it does hurt them and their confidence is diminished. But the broader point, which you didn't

29 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 7.

30 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 7.

31 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 13.

32 RBA Minutes of the Monetary Policy Meeting of the Reserve Bank Board, Sydney, 5 November 2019 <https://www.rba.gov.au/monetary-policy/rba-board-minutes/2019/2019-11-05.html> accessed 13 February 2020.

33 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 13.

34 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 13.

> articulate there, was that confidence is really responding to weak wage growth and falling housing prices. So I don't think what we are doing is damaging confidence. I hope in the end it leads to a stronger economy and more confidence.'[35]

2.24 The committee asked what research the RBA was conducting to investigate whether individuals are investing more in the stock market to pursue returns they are unable to achieve via savings accounts. The Governor advised that is difficult to obtain data to examine that question, but that equity prices are increasing and demand is one of the reasons why. When asked if this was a search for growth in a low interest rate environment, he responded:

> It's a search for return, isn't it? When people are getting very low interest rates on their term deposits, some people look for other assets to buy. Some of them go into equities and some of them go into more structured products which they need to be very careful about.[36]

2.25 The committee asked if this sort of investment raised concerns around the risk and consequences of a low interest rate environment. The RBA said its research showed that while the price-earnings ratios had risen in Australia, they were not yet at concerning levels. The RBA noted 'they're on the high end, but they've been certainly considerably higher in the past.'[37] The RBA explained:

> The other thing to point out is that if you—and this is an if—believe that interest rates are going to be lower for a longer period of time, you would expect PE ratios to be on the high end. If I take that into account and I look at PE ratios, I think they're not particular high. They've certainly been a lot higher at episodes in the past where there is clearly a large risk element to them. So they've gone up, and if I use that as a shorthand assessment of the degree to which people are stretching for yield I don't think I would characterise them as being at a particularly elevated level to cause a large amount of concern.[38]

2.26 The Governor added that this was partly the intent of monetary policy: 'you reduce the interest rate on the risk-free asset and people take a bit more risk.'[39] The Governor continued 'coming back to the point I raised in

35 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 13.

36 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 26.

37 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 7 February 2020, p. 26.

38 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 7 February 2020, p. 26.

39 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 26.

the beginning: it's possible to have too much of a good thing. To date I think it's been a healthy adjustment in asset values.' [40] He noted that investors need to be aware of the risk attached to higher returns advising that 'in the current environment there's a possibility that some people forget the risk and just focus on the return.'[41]

2.27 The committee asked the Governor what would trigger the RBA to be concerned with a shift towards higher-risk investing. The Governor replied:

> If we saw people investing in complicated mortgage products, structured products—big inflows into those—we'd want to make sure, together with ASIC, that people understood what they were doing. More broadly, the focus is on debt rather than asset prices. I'd be concerned if I saw a rapid escalation in borrowing because of low interest rates.[42]

Impact of the novel coronavirus (COVID-19)

2.28 In his opening statement, the Governor noted the recent coronavirus outbreak (now named COVID-19) as a potential source of unrest for the economy but told the committee that 'it is still too early to tell what the impact is going to be.'[43] He explained that examining the impact of the 2003 outbreak of SARS may provide a guide for the sort of impact to be expected.

2.29 The February *Statement on Monetary Policy* noted the uncertainty around the severity of the outbreak and how long it may last for:

> The effects of the outbreak are likely to flow through to other economies, particularly in east Asia, including via sharply lower Chinese outbound tourism, weaker Chinese demand for other exports and disruption to global supply chains. As China and east Asia are large trading partners for Australia, overall growth in Australia's major trading partners is expected to be a little lower in 2020 before picking up in 2021. There is considerable uncertainty regarding the duration and severity of the coronavirus outbreak. If it persists for an extended period, the effect on economic activity is likely to be larger than currently projected. The outlook for China,

40 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 26.
41 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 26.
42 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 27.
43 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 2.

> and how policy responses there could affect China's demand for Australia's exports and the exports of Australia's other key trading partners in Asia, remains an important consideration for the Australian economy.[44]

2.30 The committee sought clarification around the differences between the impacts of the 2003 SARS outbreak and this coronavirus outbreak. It was particularly interested in the outbreaks' impacts on export markets, the Australian education sector and tourism. The Governor noted 'the SARS experience does provide a kind of baseline', but that China is a much larger player in the global economy now than it was in 2003.[45] He explained that the impact is likely to be bigger for a range of reasons:

> …links with China are much more extensive than they were. The Chinese population is much more mobile than it was in 2003, and the Chinese economy in 2003 was going very strongly and it took a hit of two per cent in one quarter but it bounced back quickly. Growth now is slower and the capacity to bounce back and have stimulus measures isn't as great. More people are being affected now than with SARS. It's more contagious, but it's not as deadly. So there are more people being affected, and the response by the Chinese authorities in terms of stopping people moving around and quarantining is much more extensive than it was with SARS so the interruption to normal life in China is much bigger than it was.[46]

2.31 The Governor said that if the rate of infection does not slow, then the interruption to the Chinese economy will be increased, which will have impacts on the Australian economy. He noted that one of the first sectors hit will be education with international students potentially unable to travel to Australia.[47] The Governor explained that it is complicated to predict the full impact:

> It's affecting tourism, obviously, but as well, of course, there were fewer people leaving Australia to go to China. They're staying here and spending money. So there is a small offset. We are hearing some reports of interruptions to supply chains. Many Chinese or Australian companies had inventories so they could deal with factory shutdowns for a while, but they can't do that indefinitely. We have heard some reports of interruptions to

44 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 6.

45 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.

46 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.

47 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.

> supply chains and firms having to scale back. There are some reports of Chinese companies claiming force majeure—that something has happened and they can't deliver on their agreements. That hasn't been happening on a widespread scale yet, but, if this goes on for much longer, I think we will hear more cases of that. The potential risk to the Australian economy is bigger than SARS, and the truth is that none of us know how this is going to play out. If the infection rate comes down quickly, I think it will stabilise and we'll bounce back, but, if the infection rate does not come down quickly, and the number of cases are doubling every four days, the Chinese authorities presumably will have to tighten further on the movement of people, the movement of goods and the movement of services. Because we're so integrated with China, we're going to feel the effects here.[48]

Bushfires and Drought

2.32 The February *Statement on Monetary Policy* reported on the prolonged period of drought that much of the country has been facing for the past few years. It stated 'economic activity has been adversely affected by these conditions for two years or more. Farm GDP has declined by 22 per cent since early 2017, and is expected to decline by a further 7 per cent over the remainder of 2019/20.' In regards to the bushfires, the Statement said 'the direct effects of the recent bushfires are expected to reduce GDP growth across the December 2019 and March 2020 quarters by around 0.2 percentage points, with some recovery in the June quarter and beyond.'[49]

2.33 Much of Eastern Australia has been declared as in drought for over three years. The economic impact of this sustained drought has been substantial. The *Statement on Monetary Policy* states that the drought has placed significant pressure on farm-business profits due to higher input costs 'particularly for water and livestock feed', causing a drop of 30 per cent since 2017. [50] Further to this, the *Statement on Monetary Policy* noted that the drought has affected supermarket food prices and that the data 'suggests

48 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 9.

49 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, pp. 39-40.

50 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 41.

that the drought is likely to result in these consumer food prices remaining elevated for some time.'[51]

2.34 In his opening statement, the Governor noted the potential reduction in GDP growth by 0.2 per cent due to the current bushfire crisis. The Governor noted that for the year of 2020 as a whole 'there's going to be a rebuilding effort, and, once we take this rebuilding effort into account, it's expected to broadly offset the contraction from the fires that we saw in the first couple of quarters.'[52] However, the Governor added 'the drought, though, is continuing to act as a drag on the economy and is expected to reduce GDP growth this year by a quarter of a percentage point, as it has done for the past couple of years.'[53]

2.35 The committee asked how the current drought compares to previous droughts experienced in Australia. The Governor advised that the millennial drought was more concentrated in area and created a bigger subtraction in GDP, but the current drought was going longer and affecting a larger area.[54] The RBA further explained:

> The millennial drought had two phases. There was an interim recovery, and then it came back. Those two together were very debilitating, but in terms of consecutive years it wasn't as big. One of the other things that happens is that, in the first year and a bit of a drought, meat production actually goes up as farmers reduce their herds. It's mainly on the grains side and it depends a lot on where the drought is. So, for the first year of the drought we're currently in, Western Australia was relatively less affected and it was concentrated on the east coast. That's spread since then. But this one is now about three years.[55]

2.36 When asked about the impact of the bushfires, the RBA noted that there will be a range of impacts caused by the bushfires, including a reduction in consumption, rural exports and domestic tourism, however there are a number of factors to consider, the RBA explained:

> Our forecast for specifically the effect of the bushfires is within the range of both the official sector and the private sector estimates of the impact of the bushfires. Because it is geographically very concentrated on the areas affected, you've got to scale that up to the rest of the economy and know what else is happening. We also

51 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 41.

52 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 2.

53 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 2.

54 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 18.

55 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 18.

> need to think about the insurance losses. One of the things that we've put into the forecasts for later in the year is the insurance payouts as they come in. That is actually measured as household income. We've added that to our household income forecasts. One of the things about growth is: the house burning down doesn't reduce GDP, but building a new house where it once stood is part of GDP.[56]

2.37 The RBA commented on the scale of the bushfire crisis this year, and that it made modelling of possible impacts based on previous fire events more difficult. The RBA remarked:

> Our current estimate is that around 3,000 homes have been damaged. That is the highest number by a long way of any past bushfire event. I'm looking at data going back to the fifties. It's not uncommon for bushfire season to take several hundred homes. There are a couple of other cases where bushfires have taken more than a thousand homes. The team plotted this on a log scale because the current data point is so much more. That is more than you'd really be able to attribute to population growth, so, in that sense, there has been a big increase. We've done a pretty careful adding up of where we think the effects might be.[57]

2.38 The RBA explained the difficulty in forecasting during this particular bushfire season because of additional factors not present in previous seasons, such as extended periods of smoke haze impacting major cities. The RBA explained:

> As to some of the uncertainties we have—things that are really hard to get a handle on—include things like an awful lot of smoke around areas that were quite far away from where the bushfires actually were. We don't know what the effect of that has been on health outcomes. We know that hospital admissions for people with respiratory issues have gone up, but how do you factor that into your forecasts? Did that do something to productivity? On the other hand, if there's been less rain, that means that there are fewer rain interrupted days in construction work. There are a number of factors you have to consider. Where we've landed is roughly 0.2 per cent across the December and March quarters, with the rebuild after that.[58]

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56 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 20.

57 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 20.

58 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 20.

2.39 The committee asked if other economic factors, such as high terms of trade, would offset the downward pressures of the bushfires and coronavirus. The Governor responded that, in the short term, there was an expected reduction in GDP, but the resource sector is expected to expand over the year and commodity prices should continue to be high. He noted that the construction sector is also expected to pick up throughout the year. The Governor explained that there are a number of unknowns in providing this advice:

> …we've got a number of things moving gradually in the right direction—consumption, residential construction and mining investment—and that's enough to lift growth from two per cent over the past couple of years to closer to three over the next couple. That's not guaranteed. There are some uncertainties. The adjustment of household balance sheets—how much longer does that have to run? We can't be confident. I think it's going to come to an end, but we can't be confident. And it's certainly possible that the effect of the virus will be larger than what we factored in. So there are some uncertainties, but the baseline we're working with is growth picking up.[59]

Climate change

2.40 The committee asked about the work the RBA is doing to model the potential impacts of climate change on the economy. The Governor noted that 'we have no particular role in the discussion about how the economy should react to climate change.' [60] He explained that the RBA is focused on 'trying to understand the impacts on the economy, on our financial markets and the financial system.'[61]

2.41 The Governor explained that climate change is changing the patterns of production, investment and the costs of insurance as well as the price of assets. But, he advised that there will also be opportunities in new industries as a result of climate change adaptation. The Governor explained:

> The effects are pervasive. Our job is to try and understand them. There are also effects in the financial system—the value of assets change because of climate related issues, so, for the insurers and for banks lending to companies whose assets move up and down.

59 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 21.

60 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 17.

61 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 17.

> We're working with the other regulators to make sure that financial institutions disclose those risks so that people can understand the investment risks. I think the effects are significant, and we're trying to understand them, just as we're trying to understand the effects of many other things on the economy, investment, dynamism. It's just one of the things in the mix.[62]

2.42 When asked if these issues have always been present in Australia–the risk of cyclones, droughts and bushfires–and whether climate change is just a different iteration of these ongoing natural threats, the Governor commented:

> The judgement of most people is that, with the temperatures being higher and more variable, we're going to see more volatility, and with volatility comes changes in production, investment, insurance and asset values. How quickly that will play out, we don't know, but, with higher temperatures and more variable conditions, the patterns we've always seen are probably going to be amplified. We need to prepare for that, and institutions need to disclose their risks. So I'm not disputing that it's always been there, but it's quite plausible that it's become bigger.[63]

The labour market

2.43 The RBA's February *Statement on Monetary Policy* reported that 'employment growth is expected to increase over time, after having eased a little lately. As this occurs, the unemployment rate should also come down.'[64] The Statement cautioned, however, that 'the central forecast does not envisage a repeat of the recent unusually strong increase in labour force participation, but this cannot be ruled out if employment growth turns out to be stronger than expected.'[65]

2.44 In response to questions from the committee regarding the accuracy of forecasting completed by the RBA, the Governor advised 'we've had employment growth of two to 2½ per cent for quite a few years and, in the normal course of events, you would've expected that to drive the unemployment rate lower'. He went on to explain that 'the main reason

62 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 18.

63 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 18.

64 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2019, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

65 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2019, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

that it hasn't happened is that participation has risen a lot.'[66] The Governor went on to note that this is not necessarily a bad thing, as it meant more Australians have jobs. He later commented on the unusual nature of this additional labour supply:

> From a historical perspective, an unemployment rate of 5.1 per cent is quite reasonable, but I think it is quite possible and it is desirable to have a lower rate. If you had told me three years ago we would have employment growth averaging close to 2½ per cent, I would have thought the unemployment rate would be close to four now. But the big shock, the big surprise, has been the rise in labour force participation. There has been no shortage of jobs growth in Australia. In fact, it's been very strong. But it's been met with a lot of extra labour supply.[67]

2.45 The Governor told the committee that the relationship between the employment rate and inflation has been changing around the world and that 'we've got to be realistic about what can be achieved with our instrument in a world where the relationship between unemployment and inflation is much weaker than it once was.'[68] He added:

> We're seeing this in every country around the world. There are countries with unemployment at its lowest in 40 or 50 years and inflation is still not picking up. So, something's changed in inflation dynamics around the world, and the same is true in Australia, and we can't really hide from that. It just means that progress towards the inflation target is going to be slow, and I hope steady, and that's the forecast we're producing today—slow and steady progress, and the idea that you would try to accelerate that progress with super-easy monetary policy doesn't make sense and doesn't pass the risk-benefit calculus that we were just talking about.[69]

2.46 The committee asked the Governor to explain why the participation rate was increasing. The Governor noted that there are a number of factors, including the greater availability of flexible work options explaining that 'there are multiple things going on. One is opportunity.'[70] The Governor advised:

66 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 8.
67 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 11.
68 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.
69 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.
70 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.

> When I entered the workforce you were faced with the choice of working 40 hours a week or zero. Many women and older people chose zero. They didn't want to do 40, either because of family reasons or health reasons, so they chose zero. Today you can choose five, 10, 25, 30, so the workforce is much more flexible, employers give people the flexibility and job design is more flexible, so people have the opportunity to work. It's not surprising to me that, as a result of that, you're seeing increased female participation and increased participation by older people who get to, say, 65 and can cut down hours and stay in the labour force.[71]

2.47 The Governor advised that 'one-third of the workforce now works part time. Most of those people who work part time actually say they want to work part time and they're broadly happy with the hours they work.' [72] He also noted the increase in demand for services in health and education, which has driven these flexible opportunities. The Governor explained that weak wage growth and higher levels of debt is also part of this trend:

> Another part of the story is the pressure on household budgets. Wage growth has been weak; people have decided, maybe a spouse or an older person, to stay in the workforce longer. It's also the case that people are carrying debt into retirement or into their later life. Once upon a time, by the time you were 55 you'd probably paid off your mortgage, but many people now, at 55 and in their 60s, have still got mortgage debt. We've got higher housing prices, people have borrowed a lot to buy the house, or maybe to help out their kids or their grandkids, and they're staying in the workforce longer. So it's a combination of both opportunity and budget pressures. [73]

2.48 The Governor was asked about recent trends in the underemployment rate in Australia. He said that while approximately three-quarters of part time workers are happy with the hours they work 'roughly a quarter are unhappy with the hours they work and they would like to work more hours.'[74] The Governor advised that underemployment would be expected to decline 'if there were a pick-up in labour demand, many of those people could work more and that wouldn't put any upward pressure on inflation.'[75]

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71 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.

72 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.

73 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 15.

74 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 23.

75 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 23.

2.49 The committee asked about the dynamics of an increase in workforce participation, but slow movement in wage growth. The Governor told the committee this phenomenon seemed to based, to an extent, in uncertainty in the global economy. He said:

> I think there's something deeper going on with wages, other than just this rising participation. It's this sense of uncertainty and competition that people have, and this is kind of global. Most businesses are worried about competition from globalisation and from technology, and many workers feel that same pressure.'[76]

2.50 The Governor added that there are a number of uncertainties around automation and off-shoring that have lessened workers capacity to ask for wage increases and for business owners to offer them. The Governor commented:

> …the bargaining dynamics, because of globalisation and competition for workers, is less than it used to be. And firms are less inclined to bid up wages to attract workers because they're worried about their cost base and competition. So globalisation and changes in technology mean that everyone feels more competition.[77]

Superannuation Increase

2.51 The committee asked the Governor about the research being undertaken to model the potential impact of the increase in mandated employer superannuation contributions to 12 per cent. The RBA explained that they 'have looked at a range of studies focused on examples of things that are benefits to the worker' and that the central focus of their research was to answer the question 'to what extent would wages growth be lower than it otherwise would be because you've got this other benefit that's not cash wages?'[78]

2.52 The committee asked for clarification as to how the RBA treats superannuation, when considering its impact on wage growth. The RBA advised that it has looked at examples domestically and internationally where there has been an increase in non-cash benefits. The RBA explained that:

76 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 16.

77 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 16.

78 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 25.

> Historically, about 80 per cent of the increase in the non-cash benefit tends to show up as somewhat slower wages growth than you would otherwise have seen.[79]

2.53 The RBA noted that not all workers will have their superannuation increased, as many public sector workers already receive 12 per cent or more in employer superannuation and therefore the forecasting being undertaken 'is mainly a private sector story'.[80] The RBA advised that they have assumed that this increase will be offset by slightly slower wage growth. The RBA clarified that, while an increase to superannuation contributions will not reduce wages, workers may not welcome an increase at this stage, and explained:

> Given that wages growth is already very low relative to historical experience, I think that would have—again, Phil was talking earlier about people's risk aversion. One thing we know is that people are loss averse. Workers are much more likely to resist a reduction in wages growth than they are to forgo what otherwise might have been faster wages growth.[81]

2.54 The Governor noted that another consequence of an increase in the superannuation rate could be to bring down the savings rate of individuals:

> To think about the effect of that on the economy, you've also got to take into account that when compulsory savings go up, there's some offset in voluntary savings. So if you have to save more through super, you might save less voluntarily and therefore your consumption doesn't move.[82]

Household sector

2.55 The RBA reported in its February *Statement on Monetary Policy* that 'in the September quarter, consumption growth was weaker than earlier expected, and is likely to remain subdued in the December quarter.'[83] The *Statement on Monetary Policy* said that 'recent data have been consistent with households gradually adjusting their spending to the slower trend rate of income growth'. It advised that this accelerated with declining

79 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 25.

80 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 25.

81 Dr Luci Ellis, RBA Assistant Governor (Economic), *Transcript*, 7 February 2020, p. 25.

82 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 26.

83 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

house prices, and that 'consistent with this there was also an increase in mortgage payments over the second half of last year.'[84]

2.56 The *Statement on Monetary Policy* noted that 'consumption growth is expected to recover gradually over the course of this year and next.'[85] It noted that low interest rates, faster income growth and improved household wealth are fuelling this recovery. However, the *Statement on Monetary Policy* also noted some diminished consumer confidence:

> The Board took note that some survey measures of confidence about the future had declined, although measures of current business conditions and households' views about their finances, which tend to be more indicative of economic decisions, remain around average.[86]

2.57 The committee was interested in whether lower interest rates would push up house prices, and whether there was inconsistency in the RBA's approach to this topic, given in August the RBA did not believe lower interest rates to be the key driver in pushing up housing prices.[87] The Governor commented that it was a complex story, without a single driving factor. He explained:

> At the last hearings, we discussed a whole bunch of structural factors that were affecting housing prices as well: population dynamics, the rate of new construction and, at some point, Chinese investors buying Australian properties. It's a kind of rich story, but interest rates are part of the story. I've never stepped away from that. But, six months ago, I did not see interest rates as the main thing that were driving housing prices. Six months on, the cuts in interest rates that we have had have had a noticeable effect on housing prices. At some points, interest rates are the main drivers. At other points, population dynamics are the main drivers.[88]

2.58 The Governor noted that at different times, different factors have come to influence house prices to differing degrees. The committee asked if the ongoing lower interest rate environment meant people were able to

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84 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2020, <https://www.rba.gov.au/publications/smp/2020/feb/>, accessed 13 February 2020, p. 2.

85 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

86 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2020, <https://www.rba.gov.au/publications/smp/2020/aug/>, accessed 13 February 2020, p. 2.

87 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 9.

88 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 9.

borrow more, thus pushing up the price of houses. The Governor commented:

> Lower interest rates do boost asset prices, including housing prices. I'd take that as a given. I've never stepped away from that. I think it's a fundamental here. My recollection of the discussion last time is that, in different markets, housing prices were doing quite different things. In Perth they were declining. In Darwin they were declining. In Hobart they were rising very quickly. Yet we've got the same interest rate across the economy. So the point I was trying to emphasise last time is that these structural factors are important as well. At the moment, though, the structural factors are particularly important. The dominant factor at the moment is lower interest rates.[89]

2.59 The committee asked if lower interest rates and higher housing prices was a positive development. The Governor responded that he believed it has allowed households to pay off more debt and adjust their balanced sheets, but he questioned whether having high house prices relative to incomes was a positive in the long-term. The Governor continued:

> My own personal perspective is no—that there are things that we could do on the structural side, even with low interest rates, to have a lower level of housing prices relative to income. You see that in the United States. Housing prices relative to people's income, across the country as a whole, are much lower. Yet their interest rates, by and large, over the past decade have been lower than ours. They've got lower average interest rates and lower average housing prices relative to income. Why is that? Structural factors relating to the supply of and demand for housing.
>
> My own view is that society would be better off having lower housing prices relative to people's incomes. It's because it's the result of structural factors—monetary policy and everything—that we can't do anything about that. It's a complex picture. But in the last six months the increase in housing prices has been a positive development for household balance sheets. And because it is positive for household balance sheets it is positive for spending and positive for the economy and jobs. But we can have too much of a good thing.[90]

89 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 9.

90 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 10.

The interaction between monetary and fiscal policy

2.60 The committee asked what kind of fiscal policy initiatives might aid in boosting the economy. The Governor identified an increase in investment as a key factor. He said 'some of that could come from the public sector. Ideally a fair chunk of it would come from the private sector as well.'[91] The Governor noted that infrastructure is an area with capacity to take more investment, due to rising populations in major cities and the need to upgrade existing infrastructure to accommodate this growth.[92]

2.61 The Governor noted that the change in effectiveness of monetary policy is an issue being grappled with around the world in the current low interest rate environment. He elaborated:

> In the policy circles, not just in Australia but elsewhere, there's a broader discussion going on at the moment about the role of monetary and fiscal policy in macrostabilisation, because, with many central banks at zero or very close to zero, the scope for lowering interest rates further, if we get hit by a downward shock—a bad shock—is very limited, so the scope for monetary policy to play that stabilisation role over the next little while is limited in most countries. [93]

2.62 The Governor explained that he did not have an answer as to why monetary policy seems to be no longer as effective as it once was. He stated that it will be 'quite an important public policy issue over the next decades' and the place of fiscal policy will need to be discussed with caution because 'some people argue that fiscal policy could play a greater role and I say, 'we've tried that in the past, and it didn't really work out that well.'[94]

2.63 With regards to quantitative easing (QE) the Governor noted in his opening statement that the conditions for QE have not been met in Australia and were not expected to be met. He advised:

> …we would only consider QE if there was an accumulation of evidence that, over the medium term, we were unlikely to achieve our objectives of full employment and inflation target. As I have said on other occasions, including before this committee, in the event that the country did find itself in that position, I would hope

91 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

92 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

93 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

94 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

> that policy options other than monetary policy were also on the country's agenda.[95]

2.64 The Governor identified structural policy reform as an area that deserves more focus and that could have a more profound effect on the economy than either monetary or fiscal policy. The Governor said:

> The real challenge we have is to make real wages grow at a faster rate than they have over the past five years, and that really is from structural policy. That doesn't come from short-term fiscal stimulus. It comes from making Australia a great place to invest, expand, innovate and hire people. To bring the sense of dynamism that we've had in previous decades and generations back to Australian business and government—that's the challenge you have. The central bank can't do—I can describe the situation; that's all I can do. The challenge is really for businesses to take advantage of those fantastic opportunities out there and for government to do its bit and to help create the environment where businesses want to take those opportunities.'[96]

2.65 The Governor cautioned that, should a sharp downturn occur in the near future, the RBA does not have the room to lower interest rates much further. The Governor emphasised that at the moment 'we don't think we need more stimulus. What we do need is: structural reform to make Australia—I'll say it again—a great place to invest, expand, innovate and hire people.'[97]

Productivity

2.66 The committee asked the Governor about the decline in labour productivity and the impact this was having on the broader economy. The Governor told the committee he believed the weak productivity growth is linked to low levels of investments relative to GDP. He explained his position:

> I fear that our economy is becoming less dynamic. We're seeing lower rates of investment, lower rates of business formation, lower rates of people switching jobs, and in some areas lower rates of R&D expenditure. So right across those metrics it feels like we're

95 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 4.

96 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

97 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 24-25..

> becoming a bit less dynamic. I worry about that for the longer term.[98]

2.67 The RBA further explained that productivity is 'not directly measured in the national accounts', rather it is a calculation from GDP growth and employment growth.[99] The RBA advised that low productivity growth was entrenching low wages growth and this could potentially impact on Australians' standard of living:

> What I'm increasingly concerned about is the low productivity growth, and the prospects for that to continue, because if productivity growth is low, it means real wage growth is low, the budget is going to come under greater pressures, the value of people's assets won't rise at the rate they expect and people's incomes won't rise.[100]

2.68 The Governor noted that continued spending on infrastructure could help in this regard and would 'help both medium-term productivity growth and the short-run growth dynamic.' [101]

Conclusion

2.69 Australia's economy has experienced a period of slow growth, with low growth in household incomes weighing on consumer spending. However, there are signs the economy has reached a turning point and that a combination of the recent tax cuts; the low level of interest rates; ongoing spending on infrastructure; the growth in some housing markets; and a more positive outlook for the resources sector will support growth over the coming years.

2.70 The recent bushfire season is expected to cause a 0.2 percent reduction in GDP for the whole of 2020, with most of the downward pressure being felt in the first two quarters, and a subsequent upswing once rebuilding of homes and infrastructure commences later in the year.

2.71 The impact of the coronavirus (COVID-9) is still to be determined, and is very much dependent upon how long the shutdown in China continues, but it has the potential to have a much greater impact to the economy than the SARS outbreak in 2003.

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98 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 10.

99 Dr Luci Ellis, RBA Assistant Governor (Economics), *Transcript*, 7 February 2020, p. 12.

100 Dr Luci Ellis, RBA Assistant Governor (Economics), *Transcript*, 7 February 2020, p. 12.

101 Dr Philip Lowe, RBA Governor, *Transcript*, 7 February 2020, p. 22.

2.72 While noting the RBA has struggled to meet its inflation target in recent years, the inflation target framework has anchored inflation between 2 and 3 percent since 1990. The committee will continue to monitor the RBA's effectiveness in meeting its inflation target over time and will scrutinise the RBA for its performance against this benchmark.

2.73 The committee notes that the prevalence of downside risks in the global economy means that it is prudent for the RBA to consider all options for monetary policy if a serious downturn were to occur.

2.74 The committee is aware that many Australians, particularly those relying on interest-bearing deposits for their income, have been negatively affected by persistently low interest rates. While the committee recognises that low interest rates may encourage people to borrow and invest, it also understands that low rates reduce interest income for others. The committee will continue to hold the RBA to account for the effects of its rate decisions on both borrowers and depositors.

2.75 The committee notes the RBA questions whether high and rising house prices are good for the economy.

Mr Tim Wilson MP
Chair
4 March 2020

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Friday, 7 February 2020 – Canberra

Reserve Bank of Australia

Dr Philip Lowe, Governor
Dr Guy Debelle, Deputy Governor
Dr Luci Ellis, Assistant Governor, Economic
Ms Michele Bullock, Assistant Governor, Financial System

Private briefing

Wednesday, 5 February 2020 – Canberra

Dr Sally Auld, Chief Economist, JP Morgan

B

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

The Treasurer and the Governor of the Reserve Bank

19 September 2016

The Statement on the Conduct of Monetary Policy (the Statement) has recorded the common understanding of the Governor, as Chair 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 and stable inflation. Effective management of inflation to provide greater certainty and to guide expectations assists businesses and households in making sound investment decisions. Low and stable inflation underpins the creation of jobs, protects the savings of Australians and preserves the value of the currency.

Both the Reserve Bank and the Government agree that a flexible medium-term inflation target is the appropriate framework for achieving medium-term price stability. They agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. This formulation allows for the natural short-run variation in inflation over the economic cycle and the medium-term focus provides the flexibility for the Reserve Bank to set its policy so as best to achieve its broad objectives, including financial stability. The 2-3 per cent medium-term goal provides 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.

Relationship between the Reserve Bank and the Government

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.