HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS
REVIEW OF THE RESERVE BANK OF AUSTRALIA ANNUAL REPORT 2021
16 SEPTEMBER 2022

RBA01QW: [van Manen]

How does the RBA take into account the personal and social cost resulting from potential higher rates of unemployment / underemployment resulting from its focus on inflation rather than ensuring unemployment / under employment is minimised through its policy settings?

Answer:

The RBA has a mandate to promote price stability, full employment and the economic prosperity and welfare of the people of Australia. Price stability is a crucial precondition for sustainable long-term economic growth and without it, it is not possible to achieve a sustained period of low unemployment. Low and stable inflation underpins the creation of jobs, protects the savings of Australians and provides households and businesses with greater certainty. When inflation is low, it is something that most people don't normally need to worry about. High inflation damages our standard of living, creates additional uncertainty for households and businesses, erodes the value of people's savings, worsens inequality and makes it very difficult to sustain, or increase, real wages.

These objectives (of price stability, full employment and economic prosperity and welfare) allow the Reserve Bank Board to focus on price stability, alongside the implications of monetary policy for economic activity and levels of employment. In the short run, the RBA faces a trade-off between these objectives because employment and inflation respond to a change in interest rates in opposite directions. However, in the long run, monetary policy can control inflation but it cannot easily change the long-run level of the unemployment rate. A theoretical explanation of this is provided below.

The flexible inflation targeting framework provides the Board with the flexibility to pursue price stability in a way that, in its judgement, best contributes to full employment and the general welfare of the Australian people. Monetary policy decisions are often difficult. Higher interest rates are unwelcome for many people, especially those who have borrowed large sums over recent times. Higher interest rates are putting pressure on households, at the same time that higher petrol prices and grocery bills are squeezing budgets. The alternative of allowing higher inflation to become entrenched would be even more difficult and would ultimately require much higher interest rates to combat, which would be very costly in terms of lower growth, higher unemployment and damage to Australia's longer term economic prospects. The experience of the 1970s is a case in point. The policy challenge for the RBA is to return inflation to the 2–3 per cent target range while, at the same time, keeping the economy on an even keel. The Board seeks to return inflation to target while the economy continues to grow and unemployment remains low.

A theoretical explanation

The short-term trade-off between inflation and the unemployment rate is depicted by the downwards-sloping Phillips Curve, which provides a framework for thinking about monetary policy (Figure 1). The relationship indicates that as the unemployment rate falls, inflation will rise; the non-linear relationship between the two variables means that the further the unemployment rate falls below the natural rate or the NAIRU[1], the faster inflation will accelerate (depicted by a move from

[1] The NAIRU is the non-accelerating inflation rate of unemployment. It is the lowest unemployment rate that can be sustained without causing wages growth and inflation to rise.

point A to B in Figure 1). The converse is also true; a rise in the unemployment rate is associated with declining inflationary pressure. By reducing interest rates, a central bank could lower unemployment if it is willing to accept higher inflation – or, by increasing interest rates, it could reduce inflation at the cost of higher unemployment. However, it cannot sustainably achieve both unemployment that is below the NAIRU and low and stable inflation at the same time.

However, in the long run, the inverse relationship between unemployment and inflation disappears. This is because households and businesses adjust their inflation expectations and demand higher wages to compensate for higher future inflation. As labour costs increase, some businesses reduce their employee headcount and this continues until the unemployment rate returns to a level consistent with the natural rate at a new higher rate of inflation (depicted by the move from point B to C in Figure 1). This means that, while contractionary policy will push the unemployment rate temporarily higher, it will revert to the natural rate as workers adapt their inflation expectations in the longer run.

Monetary policy can influence fluctuations in the unemployment rate around the NAIRU in the short run, but it cannot easily change the long-run level of the unemployment rate. To do this, policymakers must look beyond monetary policy to the government policies that more directly influence the NAIRU.

Figure 1

The Short-run and Long-run Phillips Curves

For more information, see:

Reserve Bank of Australia (2016), 'Statement on the Conduct of Monetary Policy'. Available at https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html

Reserve Bank of Australia, 'The Non-Accelerating Inflation Rate of Unemployment (NAIRU)'.

Lowe P (2022), 'Inflation and the Monetary Policy Framework', Speech to the Anika Foundation, Sydney, 8 September.

RBA02QW: [van Manen]

Is the characterisation by the RBA of a higher-than-normal savings rate in fact incorrect, as the present rate of approximately 14 per cent is similar to the rate in the 60s, 70s and 80s? So why is the RBA concerned about a return to historical saving ratios?

Answer:

The household saving ratio declined to 8.7 per cent in the June quarter 2022, but remained above its average of 6.4 per cent in the decade leading up to the pandemic. While ongoing structural changes in the economy mean that there is usually some uncertainty about what is a 'normal' level of the saving ratio, recent history (excluding major recessions) provides one of the best guides. In contrast, the much higher saving ratios observed in the 1960s, 1970s and 1980s are less useful for establishing what is normal, owing to the significant changes to the structure of financial system and economy that have occurred over the past half century, as well as to measurement issues.

The decline in the saving ratio since the 1960s partly reflects how income is classified between the household and business sectors in the national accounts. The sharp fall in gross mixed income of unincorporated enterprises (which is classified as household income for the purposes of calculating the household saving ratio) as a share of household income since the 1960s mainly reflects the trend toward incorporation of businesses, which, in national accounting terms, has reduced measured savings in the household sector and increased measured savings in the corporate sector. Previous research finds that this measurement issue can account for up to one-half of the overall decline in the household saving ratio since the 1970s.

The shift to a low-inflation environment in the 1990s also contributed to the decline in measured saving. Several studies have noted that measures of household savings are distorted by inflation since, in effect, the national accounts count interest payments and receipts on a nominal rather than a real basis. In other words, the accounts do not record the capital transfers from lenders to borrowers affected by inflation. As inflation declines, the level of savings required to maintain a given level of real wealth falls. Studies find that the decline in gross private saving since the 1970s is more muted after an adjustment is made for the effects of lower inflation.

Another factor that contributed to the decline in household saving during the 1980s and 1990s was the deregulation of the financial sector, which removed restrictions on households' access to finance, allowing them to increase their borrowing. In addition to allowing households to fund increases in their consumption, the expansion in borrowing after deregulation also boosted housing prices, and the subsequent increase in net wealth raised spending via the 'wealth effect'. In turn, this reduced the savings ratio as households could use the capital gains (not counted in income) to fund consumption. However, unlike the other factors discussed above, the effects of deregulation on the saving ratio is present only while households make the transition to higher levels of debt (a process that can take many decades).

For further information, see:

Anstie R and A Pagan (1983), 'Inflation and the Consumption Ratio', *The Effects of Inflation: Theoretical Issues and Australian Evidence*, Centre for Economic Policy Research, Australian National University, Canberra, pp 321–349.

Australian Treasury (1999), 'The Measurement of Saving in Australia', *Economic Roundup*, November.

Bishop J and N Cassidy (2012), 'Trends in National Saving and Investment', RBA *Bulletin*, March 2012, pp 9–18.

Edey M and L Gower (2000), 'National Saving: Trends and Policy', in D Gruen and S Shrestha (eds), The Australian Economy in the 1990s, Proceedings of a Conference, Reserve Bank of Australia, Sydney, pp 227–310.

RBA03QW: [van Manen]

Why does the RBA believe that it is prudent for households to run down savings and incur further debt at a higher cost when we already have record levels of private household debt?

Answer:

The RBA makes no assessment on whether households should choose to incur further debt – this is a decision for individual households based on their own circumstances. What the RBA has noted is that different households have different margins of adjustment as the cost of living and interest expenses increase. For instance, for households that built up saving buffers during the pandemic, some may choose to maintain their spending on non-essential items, which would result in them either saving less and/or running down some portion of their buffers. Other households may opt to reduce their spending on non-essential goods and services so as to limit the impact on their spare cash flows and saving buffers. Some households may have the option of taking on extra work if they have the capacity to do so.

Separately, the RBA closely monitors trends in household indebtedness, and the October 2022 *Financial Stability Review* provides the most up to date assessment on related issues for households and the financial system.

RBA04QW: [van Manen]

Australian Government Bonds

Please advise:

a. The total value of Australian Government bonds on issue?

b. The total value of Australian Government bonds held by the RBA?

c. How the RBA accounts for Australian Government Bonds at maturity?

Answer:

a. As at 30 September 2022 there were $824.5 billion face value of nominal Treasury Bonds on issue, and $37.7 billion face value of Treasury Indexed Bonds on issue. See https://www.aofm.gov.au/data-hub

b. As at 30 September 2022 the RBA held $286.0 billion face value of nominal Treasury Bonds. See https://www.rba.gov.au/statistics/tables/xls/a03hist.xls

c. At maturity, the Australian Government pays bond holders the face value of maturing Australian Government bonds. The RBA will be treated in exactly the same way as any other bond holder, and the Australian Government will pay the RBA the face value of maturing bonds held by the RBA. As the Australian Government banks with the RBA, this will involve the RBA debiting the Australian Government's bank account. The RBA's balance sheet will shrink when this happens: the value of RBA assets (the Australian Government bonds held by the RBA) will fall on maturity, and the value of RBA liabilities (in this case funds held in the Australian Government's bank account at the RBA) will fall by the same amount.

Reserve Bank of Australia
7 October 2022