HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS
REVIEW OF THE RESERVE BANK OF AUSTRALIA ANNUAL REPORT 2021
17 FEBRUARY 2023

RBA01QW (van Manen)**:**

The RBA has previously acknowledged that there is a lag between when monetary policy decisions are made and when the impacts of those decisions begin to be seen. Can the RBA please advise the following:
a. The timing of when the impacts occur and if the RBA does not know this why not?
b. What the quantitative impacts are and whether they are positive or negative for the economy?
c. What are the distributional impacts, who are the winners and losers, and what is the net impact on the economy?

Answer:

a) The bulk of the impact of changes in the cash rate on economic activity and inflation are estimated to occur after about 1–2 years (see Ballantyne et al (2019) and Read (2022)). Effects on some economic variables, such as demand for credit, the exchange rate and asset prices (such as housing prices), are evident much sooner (see, for example, Saunders and Tulip (2019)). The effects on the cash flows of borrowers and lenders generally come through quite quickly, though this depends in part on the share of fixed-rate versus variable-rate lending (See, for example Long and Variable Monetary Policy Lags | Speeches | RBA and Fixed-rate Housing Loans: Monetary Policy Transmission and Financial Stability Risks | Bulletin – March 2023 | RBA).

b) Monetary policy decisions affect the economy through a range of different transmission channels (see, for example, The Transmission of Monetary Policy | Explainer | Education | RBA). When interest rates are increased, this typically results in economic activity growing more slowly than it otherwise would have done, and inflation being lower than otherwise. Quantitative estimates of these effects depend to some extent on the model used to obtain the estimates; estimates of the maximum effect after a few quarters in the academic literature and the RBA's own models typically fall in the range of output being ¼–¾ percentage points lower, and year-ended inflation ⅛–½ percentage points lower, after the policy interest rate is temporarily increased by 1 percentage point.

c) The most immediate distributional effect of a change in interest rates is on the cash flows of borrowers and lenders. For example, an increase in interest rates results in people with debt paying more in interest, typically to banks, while people with interest-bearing assets receive more interest. The aggregate effect of these distributional impacts is captured in standard models of the behaviour of the economy. Similarly, the effect of changes in interest rates on asset values will most affect owners of those assets, especially those with leverage. See, for example, He and La Cava (2020).

   Further distributional effects occur as the economy responds to the change in interest rates. Different households are affected differently by a rising cost of living, and so benefit to varying extents from inflation being brought back to target. For example, a rising cost of living puts pressures on lower income households, which typically have the most

constrained budgets as they spend a greater proportion of their income on essential items and have lower financial buffers. The benefits of an expanding economy and tight labour market are likewise felt most by those who were previously unemployed or underemployed.

RBA02QW (van Manen):

In the RBA's view is the current rate of inflation accelerating or decelerating?

Answer:

According to our current forecasts, inflation probably reached a peak in the December quarter 2022. It is expected to decelerate from here.

RBA03QW (van Manen):

At the 17 February 2023 hearing with the Committee, the RBA said that Australia is approaching or has reached full employment. This assumes those currently unemployed (3.7%) or underemployed (6.9%) have chosen to be so:
a. How does the RBA know this to be the case?
b. Is it reasonable to assume that a significant number of these people are actually involuntarily unemployed or underemployed for reasons including (but not limited to) lack of training, skills, access, etc.?
c. If so, which is the better tool to assist them obtain the employment – fiscal or monetary policy?

Answer:

An assessment that the economy has reached 'full employment' does not imply that those who remain unemployed choose to be so. The economic concept of full employment is achieved when demand meets supply in both labour and product markets, which is consistent with low and stable inflation. The exact unemployment (or underemployment) rate where this occurs cannot be observed directly and instead must be inferred from data. One such measure is the unemployment rate below which wages growth and inflation tend to accelerate (commonly called the non-accelerating rate of unemployment or the 'NAIRU').

a) The RBA infers that full employment has probably been reached based on the evidence of increasing wages growth and rising inflation in the components of the CPI that are most related to domestic demand conditions, supported by other indicators such as the ratio of job vacancies to unemployment and businesses' experience (as reported in the RBA's liaison program and other surveys) in hiring suitable labour. See for example Watching the Invisibles | Speeches | RBA and The Non-Accelerating Inflation Rate of Unemployment (NAIRU) | Explainer | Education | RBA.

b) Around one-quarter of unemployed people are short-term unemployed (i.e. unemployed for less than four weeks), which includes workers who have left a job and are waiting to start a new job within the next four weeks. Most of the short-term unemployed are broadly considered to be unemployed for 'frictional' rather than 'involuntary' reasons.

   For the rest of the unemployed population, it is reasonable to assume that most are currently unemployed for involuntary reasons (Ballantyne, De Voss & Jacobs (2014) and Cassidy, Chan, Gao and Penrose (2020)). There are two main causes of involuntary unemployment:

   i) Cyclical unemployment, which is the result of changes in economic conditions. Medium-term unemployment (1–12 months) is typically most representative of cyclical unemployment; this is currently around a multi-decade low of 1¾ per cent.
   ii) Structural unemployment, which stems from a more fundamental mismatch between jobs and workers. The long-term unemployment rate (>12 months) is most closely related to this and is a little below 1 per cent at present, which is low by historical standards.

c) Given the multifaceted nature of the barriers faced by the long-term unemployed, policies other than monetary and fiscal policy may also be needed. The main reason women were unavailable to start work was caring for children, while the main reason men were unavailable to work was due to long-term sickness or disability. Policies aimed at addressing these barriers to entry, as well as appropriate training, may help these people to obtain employment. These policies would be *in addition* to monetary and fiscal policy.

RBA04QW (van Manen):

Australia is now seeing a return to migration and we know this will assist in starting to fill job vacancies. What, if any, impact will this have on wage price growth?

Answer:

Many of the recent migrants are students and working holidaymakers, who often comprise a sizeable share of the labour force in hospitality, administrative roles and agriculture (see Migrants in the Australian Workforce Guidebook (grattan.edu.au). The increase in labour supply should help to alleviate worker shortages in these particular sectors. However, by consuming goods and services in Australia, migrants also add to aggregate demand, which helps create jobs across the economy.

International and domestic research finds that migration has little effect on the wages of incumbent workers overall, although there may be some short-term adjustment (see Brell and Dustmann (2019) for a review of the Australian evidence). Increased labour supply that is concentrated in low-skilled occupations or industries with worker shortages would likely reduce pressure on wages growth in those jobs. But the increase in aggregate demand that migration brings could lead to *additional* pressure on wages growth in other jobs, such as those that complement the skills of migrants (see Edo (2018)).

RBA05QW (van Manen):

What in the RBA's view is the tipping point for wage growth to become a wage price spiral, given significant supply side-driven price inflation over the past 18 months?

Answer:

A price-wage spiral would occur when both the price-setting behaviour of firms and wage increases paid to workers start to chase each other. This does not necessarily occur at any particular 'tipping point' rate of wages growth. Rather, it would involve a widespread pattern of workers seeking and obtaining wage increases to compensate for past increases in the cost of living, and then firms passing the resulting increases in their costs through to their own prices, in turn inducing further wage claims and increases.

RBA06QW (van Manen):

Whilst the RBA has explained that the term funding facility (TFF) was at a fixed rate, could you not offset a bank's liability to their exchange settlement accounts (ESA)? For example, if Bank A has a TFF of $100bn and an ESA of $200bn then they would only get paid interest on the difference between the 2 balances, i.e. $100bn at the applicable rate.
a. If not, why not?
b. Wouldn't the above solution ensure that banks are not getting a free ride at the expense of taxpayers?

Answer:

The TFF was provided at a fixed low rate. The provision of term funding at a low rate was an important policy action to support funding at a time of great uncertainty.

Action to eliminate the low-cost nature of the funding provided by the RBA would be contrary to the terms under which the funding was provided, and undermine the credibility and effectiveness of any future policy actions by the RBA.

In addition, the interest paid on ESA balances is set by the RBA as part of its domestic operations aimed at implementing the monetary policy decisions of the Reserve Bank Board and facilitating the smooth functioning of the payments system. Amending the amount paid on ESA balances as proposed could impede the effective transmission of monetary policy by creating a disincentive to hold ESA balances among banks with ESA balances below their outstanding TFF funding.

As discussed in a recent *Bulletin* article, the RBA estimates that the TFF lowered overall bank funding costs by around 5 basis points at the time that the program was drawn down. Much of this saving was passed on to customers in the form of very low interest rates on fixed-rate housing and business loans (while variable rates also declined). Banks typically hedged most of their drawings from the TFF around the time they were made, either using derivatives (which convert fixed-rate funding into variable-rate funding) or by writing fixed-rate loans. These hedges mean that banks do not benefit much from the rise in interest rates on their lending associated with cash rate increases versus the fixed cost of the TFF payments.

RBA07QW (van Manen):

In Governor Lowe's statement accompanying the latest rate rise on 7 February 2023, he said the following: 'Inflation is expected to decline this year… medium-term inflation expectations remain well-anchored, and it is important this remains the case'.

If this is truly the case and given that as of December 2022 the medium term (5 year) rolling average for inflation was 2.7% within the 2–3% average outlined in the RBA Corporate Plan, why are interest rates continuing to increase?

Answer:

If inflation does not return to the target range in good time, it would be very likely that medium-term inflation expectations would not stay well-anchored as they have so far. The five-year average of past inflation does not necessarily determine expectations of future inflation.