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Review of the

Reserve Bank of Australia Annual Report 2008

(Second Report)

House of Representatives Standing Committee on Economics

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Foreword

In September 2008, as the impact of the Lehman Brother collapse became clear, countries around the world tried to protect their economies from the downturn. The Governor of the Reserve Bank noted that by February 2009 'the resulting contraction in economic activity in the December quarter was severe in many countries, and that global growth had suffered its biggest setback in decades.'

Just twelve months later the Australian economy proved its resilience by avoiding a recession. At the August 2009 hearing the Governor was optimistic about the Australian economy and noted that Australia had several advantages including 'a sound financial system, an absence of the worst of the problems afflicting some other countries, exposure to an emerging China, and scope to use macroeconomic policies to cushion the downturn.'

In addition, the Reserve Bank acted decisively through its monetary policy decisions. In September 2008 the policy cash rate was at a contractionary level of 7.25 percent. With the collapse of Lehman Brothers it became self evident that rates would need to be cut. Where the Reserve Bank showed leadership was through the size and speed of the cash rate reductions that occurred. Between September 2008 and April 2009 the Reserve Bank reduced the policy cash rate by 425 basis points. Three rate reductions were of the order of 100 basis points each. It is also notable that the Reserve Bank held off when the policy cash rate reached three per cent. Financial markets were at one point factoring in a cash rate of less than 2 per cent. The contribution that the Bank's monetary policy made to underpinning the economy during the height of the downturn can not be underestimated and it will certainly be a benchmark response for future Governor's of the Reserve Bank to note.

While the Reserve Bank's approach to monetary policy during the height of the global financial crisis showed sound leadership the period ahead is no less challenging. It is now apparent that the Bank has turned to its core objective of inflation targeting. In October 2009 the Reserve Bank was possibly the first amongst central banks to increase rates. The Governor has made it clear that the 'emergency rates' during the crisis would be inappropriate as the economy started to grow. The Bank's objective is now to lift rates to a 'normal' or neutral setting that will provide for long term growth and core inflation in the target band.

The management of monetary policy, however, during the next six to twelve months will be associated with some risks. The first challenge for the Board is the timing and size of the rate increases. The Governor commented that 'the timing and pace of those adjustments, if and when they come, will be a matter of careful consideration, taking into account all the relevant factors, including what might be happening with market interest rates.' While the economy is returning to higher levels of growth there is still some fragility in the economy. Unfortunately unemployment could still rise and manufacturers and other export based industries are under pressure from the strong Australian dollar.

The bank must be certain that any rate rises during the next 12 months do not work against the economy's return to trend levels of growth. Conversely, the Reserve Bank needs to ensure that inflationary forces are kept in check and that medium to long term inflation is forecast to be in the target band. These challenges are why the next hearings with the Reserve Bank in February and later in August 2010 are significant. The Reserve Bank has an important responsibility to the Australian community and it will need to account for its performance particularly during the cycle ahead.

On behalf of the committee, I would like to thank the Governor of the Reserve Bank, Mr Glenn Stevens and other representatives of the RBA for appearing at the hearing on 14 August 2009. The next public hearing will be held on 19 February 2010 in Canberra.

Craig Thomson MP
Chair

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Membership of the Committee

Chair	Mr Craig Thomson MP	
Deputy Chair	Hon Kevin Andrews MP	
Members	Mr David Bradbury MP	Mr Richard Marles MP (to 15/6/09)
	Hon Julie Bishop MP (to 25/2/09)	Ms Julie Owens MP
	Mr Jamie Briggs MP (from 25/2/09)	Hon Tony Smith MP
	Hon Joe Hockey MP (to 11/8/09)	Mr Jim Turnour MP
	Ms Sharryn Jackson MP	Mr Scott Morrison MP (from 11/8/09)
	Hon Joel Fitzgibbon MP (from 15/6/09)	

Committee Secretariat

Secretary	Mr Stephen Boyd
Research Officer	Ms Bryony Dyer
Administrative Officers	Ms Renee van der Hoek

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.

List of abbreviations

ABS	Australian Bureau of Statistics
ATM	Automatic Teller Machine
CPI	Consumer Price Index
EFTPOS	Electronic Funds Transfer at Point of Sale
The Fed	US Federal Reserve
FHOG	First Home Owner Grant
G7	Canada, France, Germany, Italy, Japan, UK, and US
GDP	Gross Domestic Product
IMF	International Monetary Fund
RBA	Reserve Bank of Australia
TWI	Trade Weighted Index
UK	United Kingdom
US	United States of America
WTI	West Texas Intermediate

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Introduction

Background

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

1.2 The RBA's Governor's appearances before the committee at biannual public hearings are an important element of the Bank's accountability framework. The details of this framework are set out in the *Fourth Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Wayne Swan, MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix B, states:

> The Governor has also indicated that he plans to continue to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Treasurer expresses continuing support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy—and therefore the credibility of policy itself.[1]

1 RBA, *Fourth Statement on the Conduct of Monetary Policy*, December 2007.

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual reports of the RBA.

Scope and conduct of the review

1.4 The fourth public hearing of the committee with the RBA during the 42nd Parliament was held in Sydney on 14 August 2009.

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

1.6 Before the hearing, the committee received a private briefing from Mr Alan Oster, Group Chief Economist, National Australia Bank. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Oster's cooperation and assistance.

1.7 The committee also appreciates the provision of additional briefing material from Mr Scott Kompo-Harms of the Parliamentary Library Research Service.

1.8 The hearing was well attended by members of the public and staff and students from Sydney Secondary College, Domremy College, Fort Street High School, Mont Sant'Angelo College and SCECGS Redlands.

1.9 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. The committee welcomes the Governor's frank and open comments at the hearings. In addition, the hearings are an important means whereby financial markets can be better informed on the current thinking of the RBA.

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

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2 See: <www.aph.gov.au/economics>

3 See: <http://www.rba.gov.au>

Next public hearing with the Reserve Bank of Australia

1.11 The committee will conduct the next public hearing with the RBA on 19 February 2010 in Canberra. More details will be circulated in the weeks leading up to the hearing.

2

Monetary policy and other issues

Overview

2.1 When the Reserve Bank of Australia (RBA) appeared before the committee in February 2009, international financial markets were stabilising after the extreme turmoil of September 2008. However the effects of the events of September 2008 for the world economy and the Australian economy were only just beginning to become evident in the data.

2.2 It was clear that the contraction in economic activity in the December quarter had been severe in many countries and that global growth had suffered. Central banks eased monetary policy aggressively and Governments put fiscal stimulus packages into place.

2.3 By May 2009 Australia was performing better than most economies and signs of a turning point began to appear both domestically and internationally.

2.4 While GDP growth for most countries was still very weak, the rate of contraction was abating. Industrial production and exports picked up in Asia and the rate of growth in the Chinese economy increased. The RBA forecast a gradual recovery for the Australian economy beginning at the end of 2009. Taking into account the significant earlier easing of monetary policy and the considerable fiscal stimulus measures, the RBA kept a fairly stable monetary policy setting during this period.[1]

2.5 The International Monetary Fund (IMF) forecast in July 2009 that global activity would contract by 1.4 per cent in 2009 and expand by 2.5 per cent in 2010. This is 0.6 percentage points higher than forecast in April 2009.

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1 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.2.

2.6 It is now clear that the Australian economy has remained resilient in contrast with a very difficult international environment. During the hearing the RBA noted that Australia had significant advantages going into the financial crisis including, 'a sound financial system, an absence of the worst of the problems afflicting some other countries, exposure to an emerging China, and scope to use macroeconomic policies to cushion the downturn.'[2]

2.7 These advantages have been helpful to Australia. Recent GDP data suggests that output contracted only modestly around the turn of the year. Demand and output have strengthened slightly, with household consumption continuing to grow in the June quarter. The RBA is now forecasting modest growth of 0.5 per cent over 2009, gradually firming through 2010. [3]

Forecasts for the Global Economy

2.8 The IMF reported in July 2009 that the world economy is stabilising, but also noted that the global recession is not over:

> The downward drag exerted by the financial shock, the sharp fall of global trade, and the general increase in uncertainty and collapse of confidence is gradually diminishing. However, supportive forces are still weak. Many housing markets have yet to bottom out. Importantly, financial markets remain impaired and bank balance sheets still need to be cleaned and institutions restructured.[4]

2.9 Improvements are far from uniform across countries and economic activity and credit growth are likely to remain subdued in many economies.

2.10 The IMF forecasts that GDP in advanced economies will decline by 3.8 per cent in 2009 before growing by 0.6 per cent in 2010. In contrast, emerging Asian economies (including China and India) are forecast to grow by 5.5 per cent in 2009 and seven per cent in 2010. Growth projections for Latin America, Eastern Europe, Africa and the Middle East have been revised downwards for 2009 but have generally been revised upwards for 2010.[5]

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2 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.2.

3 RBA, *Statement on Monetary Policy*, 6 August 2009, p.74.

4 International Monetary Fund, *World Economic Outlook Update*, 8 July 2009, p.3.

5 International Monetary Fund, *World Economic Outlook Update*, 8 July 2009, p.5.

2.11 Although expansionary macroeconomic policies are supporting global activity temporarily, the IMF noted concern as to how private consumption will hold up in the United States and other advanced economies once this stimulus is removed.[6]

2.12 The RBA has noted that although the risk has decreased, the possibility of another adverse shock to some part of the global financial system cannot be ruled out.[7]

Forecasts for the Australian Economy

2.13 The RBA remains optimistic about Australia's economic outlook. Its central forecast is for the economy to grow by around 0.5 per cent over 2009, compared with a forecast contraction of one per cent in May. This revision reflects both a stronger than expected March quarter as well as more genuine strength in the economy than had been expected in May.[8]

2.14 The economy is forecast to gradually strengthen through 2010 and 2011, with growth expected to be around 3.75 per cent, or moderately above trend, by the end of the period.[9]

Table 2.1 RBA Output and Inflation Forecasts (a)

	Mar 2009	*June 2009*	*Dec 2009*	*June 2010*	*Dec 2010*	*June 2011*	*Dec 2011*
GDP	0.4	¼	½	1	2¼	3¼	3¾
Non-farm GDP	0	0	¾	¾	2¼	3¼	3¾
CPI	2½	1½	2¼	2¾	2	2	2
Underlying inflation	4	3¾	3¼	2½	2	2	2

(a) Actual GDP data to March 2009 and actual inflation data to June 2009. For the forecast period, technical assumptions include A$ at US$0.84, TWI at 66, and WTI crude oil price at US$80 per barrel and Tapis crude oil price at US$83 per barrel. Sources: ABS;RBA

Source *Reserve Bank of Australia, Statement on Monetary Policy, 6 August 2009, p. 75.*

2.15 Looking forward, consumption spending is likely to slow as the stimulus from fiscal payments to households fades. While asset prices have recovered from 2008, the decline in the net worth of household assets seen in 2008 is likely to continue, contributing to higher rates of household saving.[10]

6 International Monetary Fund, *World Economic Outlook Update*, 8 July 2009, p.4.

7 RBA, *Statement on Monetary Policy*, 6 August 2009, p.76.

8 RBA, *Statement on Monetary Policy*, 6 August 2009, p.74.

9 RBA, *Statement on Monetary Policy*, 6 August 2009, p.75.

10 RBA, *Statement on Monetary Policy*, 6 August 2009, p.74.

2.16 Home building is likely to pick up as a result of lower mortgage rates and the temporary increase in the first-home buyers grant, although apartment building may slow due to financing difficulties in that sector. Combined with public sector infrastructure spending, this activity is expected to provide support to demand.[11]

2.17 Inflation has started to fall and is expected to continue to moderate due to easing capacity pressures and labour costs. The RBA's central forecast is for underlying inflation to decline, reaching a low of two per cent by the end of 2010.[12]

2.18 On the other hand, the RBA has identified the risk that recent improvement in indicators simply reflects changes in the timing of overall spending, partly due to fiscal measures, and that over the second half of the year private sector demand will weaken again.[13]

Inflation Targeting

2.19 During the hearing the committee asked where the main threats of higher inflation are coming from within the economy. The Governor explained that people understand goods and services inflation as demand versus supply but expectations also play a part. The Governor commented that 'if we all expect inflation to continue, we behave accordingly and that helps it happen.'[14]

2.20 The Governor then explained that this tendency is problematic in a booming economy. The Governor stated:

> In that situation where the economy is booming, inflation is high and inflation expectations are starting to rise, that is obviously troubling and it is very important to keep those expectations anchored at a low level, which is part of the reason for having an inflation target, as we do.[15]

2.21 In relation to demand and supply, the Governor explained that he does not think there is a problem regarding demand versus supply and that inflation will continue to gradually subside. The Governor stated:

> On the excess demand versus supply side, clearly capacity usage has come down quite noticeably. It is not really low at this point

11 RBA, *Statement on Monetary Policy*, 6 August 2009, p.75.

12 RBA, *Statement on Monetary Policy*, 6 August 2009, p.76.

13 RBA, *Statement on Monetary Policy*, 6 August 2009, p.76.

14 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.14.

15 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.15.

> and it seems to be levelling out. But there is more spare capacity in the economy now than there was and that is part of the story that we are telling in our statement for why we think inflation will continue gradually to subside for a little while yet.[16]

2.22 The committee raised the question as to whether the Governor has any concerns regarding Australian Bureau of Statistics (ABS) methodology for forecasting underlying inflation. The Governor responded that the measure of core inflation that the Reserve Bank uses was created by the Reserve Bank and that he has no particular criticisms of the measure. The Governor did say that there are, 'one or two things in the CPI that I think are methodologically difficult.'[17] However he conceded that this would always be the case. [18]

Monetary Policy

2.23 The committee sought an update on the factors influencing monetary policy settings. The Governor began by explaining the basis of the current settings:

> …what we have got in place at the moment is an emergency setting. It is a setting of the cash rate that is the lowest for 40 years put in place in anticipation that the economy would be seriously weak... As the set of risks that you think you face start to shift, at some point you are going to have to make a response to move away from the emergency setting.[19]

2.24 The Governor then explained the importance of moving from the current emergency setting to a more normal level as the economy recovers:

> I think that there is ample evidence elsewhere in the world of problems that you ultimately get if you keep the emergency setting in place for too long… when the emergency has passed you have got to then think about withdrawing the emergency measures over time.[20]

16 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.15.
17 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.15.
18 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.15.
19 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.8.
20 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.8.

2.25 The committee asked what the Reserve Bank defined as a 'normal level' for the cash rate. While the Governor did not state a specific level he did comment that, 'it is probably noticeably higher than three'.[21]

2.26 Concerned about the possibility of interest rates rising, the committee asked the Governor what advice he could give to people thinking about buying their first home. The Governor noted that while he does not give advice to homebuyers, 'I think I would say to anybody who is contemplating taking on a variable rate obligation that interest rates could always rise and you should always allow some capacity to cope with that.'[22]

Fiscal Stimulus

2.27 The committee enquired what risk there is in over-stimulating the economy if the delivery of certain parts of the Government stimulus program were to be delayed. The Governor stated:

> At the present time I do not think we are in the position of feeling that we are going to get serious problems of imbalances arising from those delays thus far. That could change if there were to be much bigger delays, of course, but at this point the various stimulus things that have been announced over the past year are built into the numbers we put out.[23]

2.28 In a related question, the committee asked at what point the Government should consider winding back some of the fiscal stimulus measures. The Governor responded that the current projections include an automatic winding back of the fiscal measures. In regards to whether some measures should be stopped before they start, the Governor stated:

> If we are doing better than the forecast at some point, we will probably respond to that. Whether the government is able to or chooses to respond with discretionary changes in the already announced fiscal things is really up to them.[24]

2.29 The committee enquired whether there is a point at which increasing debt to pay for stimulus measures becomes counterproductive. The Governor answered that it depends how much debt there is and whether or not it is manageable given reasonable trends. The Governor stated:

21 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.13.
22 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.16.
23 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.10.
24 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.28.

> I think that the sort of federal debt we are going to see, if the projections in the budget papers turn out to be right, will be that net debt is going to go from about minus five per cent of GDP and, according to the budget figures, peak at less than 15 per cent. That is a significant change, but 15 per cent of GDP is a low number by virtually any other standard. So I do not feel that that debt burden, if that is what happens, is going to seriously impair the country's economy.[25]

2.30 Similarly, the committee sought clarification of the claim that the current stimulus measures will result in a large public debt for future generations. The Governor noted that his generation inherited public debt from his grandparent's generation and that there is no rule in economic theory that states that the optimal amount of debt is nothing. Instead, the Governor said that, when considering the level of public debt it is important to ask the question: 'is it, around a stable trend, manageable?'[26] The Governor went on to say that, considering the budget deficit is currently slightly smaller and the rate of debt accumulation somewhat slower than forecast in the budget, 'I think that will prove to be manageable.'[27]

2.31 In the course of discussion on the level of public debt, the Governor noted that the budget deficit in Australia was five per cent at the time of the financial crisis; a comparatively low level by global and Australian standards. The committee sought advice as to why the level of public debt was so low at that time. The Governor credited a legacy of conservative fiscal management in Australia compared to other countries over the past two decades. The Governor stated:

> I would say that is basically pretty conservative fiscal policy for quite a long time. Also, privatisations in the 1990s took out quite a bit of the debt that was in existence then. The privatisation of Telstra reduced debt a lot but, by and large, for probably 20 years we have had, on the whole, pretty conservative fiscal policy in this country by the standards of others. That is the legacy. It is that legacy that has made the room for fiscal policy to do what it did in the downturn—that is, move to expansion—just as prudent monetary policy for a long time meant that we had scope to cut interest rates credibly and help the economy. You earn that scope

25 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.10.

26 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.31.

27 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.31.

> on both monetary and fiscal policy by many previous years of careful management.[28]

Bank Guarantee

2.32 The committee asked what preconditions are needed for the withdrawal of the government guarantee for retail deposits and wholesale funding, as well as a likely timeframe in which such preconditions may occur. In relation to both retail and wholesale lending arrangements the Governor stated that, 'I would say that we are not far now from a world where we do not really need to have the banks using those guarantees.'[29] In regards to the retail guarantee the Governor stated:

> I do not think that the likely ending point for retail is that the financial claims scheme… could be changed. The scheme is in legislation now, I think, so that is going to be there. Most countries have some kind of deposit insurance, so that it is likely to persist.[30]

2.33 Following this, the Governor noted that most countries have specified an end date for the guarantee programs. The Governor stated:

> Most countries actually put an end date for when the guarantees would finish. A number of them have had to extend it but for most of them it is the end of this year. Really, if all those countries allow that to come to fruition and the guarantee is no longer available, I cannot really see why we are going to need it much longer. [31]

2.34 The Governor further explained that the design of the guarantee on wholesale funding is such that the banks will naturally cease participation in the program once market conditions normalise. The Governor stated:

> …when the pricing of the fee for the guarantee was set it was set in a way that we hoped would be such that when market conditions normalised it would be too expensive to issue with the guarantee and would naturally therefore fall into disuse. We are probably not that far actually from that stage. I think that it would be good for our institutions to just start to issue in their own name anyway as much as they can.[32]

28 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.11.
29 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.34.
30 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.34.
31 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.34.
32 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.34.

Housing Supply

2.35 The committee made reference to a speech given by the Governor in which he outlined a short term policy challenge of how to ensure that the current ready availability and low cost of housing finance is translated into more dwellings, not just higher prices. The committee questioned the Governor as to whether he believes that Australia is experiencing a housing bubble. The Governor stated that he never used the word bubble and does not believe that Australia is currently experiencing a housing bubble. The Governor clarified the comments made in the earlier speech saying:

> The point I was making in the talk was that, at the moment, big-ticket construction is slowing down for various reasons that we are all familiar with. A couple of years ago it was booming and the housing part was being held back by high interest rates, among other things, to make room. We do not need to do that now. This is the time when we can build more houses, and the population dynamics are such that we should be building more, I think. The physical resources are more available to do it now. The financial resources are there for the end buyers at least— interest rates are low, credit is available for home buyers. This ought to be a moment when we can get some new stock built, hopefully without too much of a run-up in the prices of existing homes. That is the point I was making. I think it would be disappointing if we cannot manage that.[33]

2.36 The committee sought further clarification on whether the Governor felt that there is a bottleneck in the supply of dwellings. The Governor responded:

> I am not an expert in the fine detail of zoning laws and those things, but I think it is demonstrably true that, certainly in this city [Sydney], the price of a marginal block of land is quite high… There are levies and so on which contribute to that. There may well be good reason to have those various charges from a community point of view, but I suppose what I am saying is that we ought to be prepared to examine the question of whether we have managed to make the supply price of the marginal dwelling higher than it really needs to be.[34]

2.37 The committee enquired more generally if central banks should have a role in dealing with asset price bubbles. The Governor explained that there

33 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.19.

34 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 19.

is a considerable amount of debate both internationally and in Australia as to whether central banks should act to control asset price inflation when there is a harmful level of leverage attached. He also noted that there is considerable debate over what tools to use to control inflation once the decision to act has been made. The Governor expressed the following view on the Reserve Bank's role in such a situation:

> I personally would not want to commit to saying, 'We're definitely never going to pay attention to asset prices and totally ignore them.' That has been shown to be a mistake, basically. But nor do I think it is our brief to aggressively chase down asset things that pop up here and there that we might personally find hard to accept or agree with, at the expense of other things that we have as our objectives. So I think that, into the future, it is going to be a matter of judicious, careful use of our instrument in trying to meet all these worthy goals.[35]

2.38 The Governor was then asked that if supply bottlenecks were mainly responsible for causing housing asset price inflation, then should the policy priority be to address those supply issues rather than put up interests rates to control house prices. The Governor stated:

> I would not be proposing a policy of raising interest rates simply because house prices were rising. It is one of the factors; it is one of the parts of the whole mosaic that is the economy to which we try to calibrate our instrument. But is it worth re-examining all these supply issues? I would say yes, without having any great expertise in being able to tell you how exactly that might be done.[36]

Labour market

2.39 Conditions in the labour market softened in 2009, with unemployment increasing and employment being broadly flat. In July the unemployment rate was 5.8 per cent, around 1.75 per cent higher than the lowest point in 2008 and 0.2 per cent below its peak.[37] This is a smaller rise in unemployment than was forecast in February 2009.

2.40 The Governor noted that there has been a significant fall in the number of hours worked and that this may be a more reliable gauge of the extent of labour market weakening than unemployment figures. The Governor compared this with earlier downturns stating that the reduction in hours

35 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.21.

36 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.21.

37 RBA, *Statement on Monetary Policy*, 6 August 2009, p.45.

has occurred across more people, rather than being concentrated among a group of unemployed.

2.41 Describing the magnitude of the current downturn in terms of employment conditions, the Governor stated, 'at this point, the fall in hours worked looks larger than what occurred in 2001, but not as large as in 1991.'[38]

2.42 The Governor expanded this observation to the broader economy saying:

> In fact, I would say that is probably at this point a reasonable characterisation of this downturn in general. That is, on the basis of the information we have at the moment, this may well turn out to be one of the shallower recessions Australia has experienced.[39]

2.43 The committee asked how monetary policy as a tool can deal with sectoral differences within the economy. The Governor replied that:

> …we have got to make policy for the aggregate, bearing in mind those sectoral differences and attuning to them as best we can. But in the end it is the aggregate that we have to pay the highest regard to.[40]

2.44 The Governor further explained that in the case of chronic youth unemployment:

> The best way to prevent that is going to be a growing economy, a flexible set of labour arrangements and an economy that is well in balance. Our job is to try to play our part in keeping that balance, which, at the moment, of course, means interest rates are unusually low. But if we keep them low too long then we will get imbalances that will not help the chronic unemployment potential for those people. So the best we are going to be able to do is a recovering economy on a balanced growth path. That is what we are aiming to achieve.[41]

Exchange rates and external trade

2.45 The RBA stated in its August *Statement on Monetary Policy* that:

> On a trade-weighted basis the Australian dollar has appreciated by 22 per cent from a trough in early March 2009 and is now 12

38 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p.4.

39 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 4.

40 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 8.

41 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 8.

> per cent above its post-float average. The appreciation in the currency continues to be underpinned by the pick-up in commodity prices and by the general improvement in global investor sentiment.[42]

2.46 The Australian dollar traded at US$78.55 cents as at the hearing date.[43]

2.47 The weakness in the global economy over the past year has contributed to a significant decline in commodity prices and Australia's terms of trade, although spot prices for coal and iron ore and for exchange-traded commodities have generally strengthened over the past three months.[44]

2.48 Australia's export performance has been surprisingly strong, underpinned by a pick-up in Chinese demand for resources and a rise in farm output. Assistant Governor, Dr Phillip Lowe explained:

> …if you look at our last nine months then our export volumes are probably up three or maybe four per cent. If we look at every other country around the world, their export volumes have fallen—in many cases by 10 per cent and in some cases by 20 or 30 per cent. So Australia has been able to sell more goods to the world in a period in which global trade has collapsed and industrial production has collapsed. There are a number of reasons for that but the main one is, in fact, China. Of our total exports 23 per cent went to China in the last quarter.[45]

2.49 Australian resource export volumes are estimated to have been broadly flat over the three quarters to June, although values have declined by nearly 30 per cent, with prices bearing the adjustment rather than volumes.[46] China's demand for resources has been an important part of the resilience of Australian resource export volumes.

2.50 Also part of the story is a recovery in Australia's rural exports. Volumes have risen by nearly 20 per cent over the three quarters to June, reflecting the recovery in production following a return to more normal seasonal conditions in 2008.[47]

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42 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 30.

43 RBA website, 'Daily Statistical Release Exchange Rates', viewed on 31 August 2009, <http://www.rba.gov.au/Statistics/exchange_rates.html>

44 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 73.

45 Dr P Lowe, Assistant Governor of the RBA, *Transcript*, 14 August 2009, p. 27.

46 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 43.

47 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 40.

2.51 Service exports have also held up comparatively well and are estimated to have risen by four per cent over the three quarters to the June quarter. This has reflected continued solid growth in travel services, which includes education services.[48]

2.52 In contrast, the volume of manufactured exports is estimated to have declined by around 15 per cent over the three quarters to June, led by sharp falls in transport equipment exports. This is broadly consistent with the experience in other economies.[49]

2.53 The Governor stated that overall, 'Australia's terms of trade are likely to be around 20 per cent lower this year than the peak last year, but they are still about 45 per cent higher than the 20-year average up to the year 2000.'[50]

United States, China and the global economy

2.54 The outlook for the global economy is looking distinctly better than a few months ago. The Governor noted that conditions in international markets have continued to improve and while there are occasional reversals, each time the recovery trend has continued.

2.55 In regards to the USA and Europe, the Governor observed that they only now seem to be reaching a turning point towards recovery.[51]

2.56 United States GDP fell by a further 0.3 per cent in the June 2009 quarter, however this was a significantly smaller contraction than the 1½ per cent contraction seen in both the December 2008 and March 2009 quarters. Exports seem to have bottomed out and importantly the housing market is showing signs of stabilisation.[52]

2.57 Significant factors weighing on the United States' economy are weakness in consumption as households seek to pay off debt and the significant rise in unemployment in the first quarter of 2009 as a result of the large contraction in output in the December quarter of 2008. Output in the USA fell once again in the June quarter of 2009.[53] As a counter to weak demand, fiscal stimulus measures, estimated to amount to around four percentage

48 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 40.

49 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 40.

50 Mr G Stevens, Governor of the RBA, *Transcript*, 20 February 2009, p.3.

51 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 3.

52 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 9.

53 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 6.

points of annual GDP, have been put in place over the 18 months to September 2010.[54]

2.58 Economic activity in the UK is similarly weak with GDP falling in the June quarter by 0.8 per cent, following a fall of 2½ per cent in the March quarter. The unemployment rate has increased significantly, but there are signs that house prices are stabilising. Likewise, economic activity in Europe looks to still be contracting, although the pace of decline has slowed.[55]

2.59 In contrast to the USA, UK and Europe, emerging Asia, notably China and India, has experienced a marked improvement in economic activity. The Governor attributed this to a handful of factors, 'the significant stimulus put in place by governments in those countries, the dynamics of the inventory cycle, the healthier state of financial systems in that part of the world and, in all likelihood, just the inherently better secular growth prospects for those kinds of countries.'[56]

2.60 Recovery has been most marked in China. Recent estimates suggest that after quarterly growth slowed to around 0.5 per cent in the December quarter, it picked up to around 1.5 per cent in the March quarter, and then accelerated to over four per cent in the June quarter.[57] The IMF has significantly upgraded its forecast GDP growth for China, bringing it to 7.5 per cent in 2009 and 8.5 per cent in 2010.[58]

2.61 The committee asked how China's strong recovery has impacted Australia. Assistant Governor Lowe stated that Australian export volumes have increased by roughly three or four per cent over the past nine months. He said that this is remarkable because it is at a time in which every other country in the world has seen a fall in their export volumes.

2.62 Assistant Governor Lowe said the main reason for this is, 'very strong demand for resources in China, largely because of the fiscal stimulus that is going on there'.[59] On top of this, Assistant Governor Lowe stated that there has been an increase in the proportion of Australia's exports going to China, 'Of our total exports 23 per cent went to China last quarter. If you look back 10 years, China was taking four per cent of our exports.' [60]

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54 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 9.

55 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 9.

56 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 3.

57 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 6.

58 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 11.

59 Dr P Lowe, Assistant Governor of the RBA, *Transcript*, 14 August 2009, p. 27.

60 Dr P Lowe, Assistant Governor of the RBA, *Transcript*, 14 August 2009, p. 27.

2.63 Growth prospects for India, Korea, Singapore and Japan are also improving.[61] Largely reflecting improvements in the situation of emerging Asian economies, the IMF raised its year-average growth forecast for 2010 by 0.6 percentage points to 2.5 per cent.[62]

2.64 The Governor noted that although the IMF has raised its forecast for global growth in 2010, the forecast for overall growth is still relatively lacklustre.'[63]

2.65 The committee sought information on the risk of inflation in the global economy stemming from high levels of debt to GDP and what implications this would have for monetary policy here in Australia. The Governor outlined two schools of present thinking concerning the global economy:

> On the one hand some countries have genuinely worried about deflation in the near term because of extremely weak demand... On the other hand there are other people who worry… about the very large budget deficits that some countries are running… we are talking about countries like the US or the UK and some others that have 10 or 12 per cent of GDP deficits and gross debt burdens going to 100 per cent and so on. So people who look at the long run look at all that and think, 'Isn't there a risk that somehow inflation will get going again? So you have got both these concerns: possibility of short-term inflation being too low, but possibility of it being too high in the medium term.[64]

2.66 In regards to how Australia should best deal with either situation the Governor stated,

> …our best bet is to have an inflation target, a flexible exchange rate which lets us set our own monetary policy without being mechanically helped up by someone else, an independent central bank to pursue that target and broad political support for that framework.[65]

61 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 73.
62 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 10.
63 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 3.
64 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 26.
65 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 26.

Household debt

2.67 Indicators of Australian household activity have been comparatively strong over the past year. Retail sales and the housing market have been buoyant since late 2008 and there has been a significant rebound in consumer sentiment in recent months.[66]

2.68 After falling by 10 per cent over 2008, household net worth has increased in the first half of 2009, with both housing and equity prices rising. In addition, household incomes have been boosted by budget measures, in particular transfer payments amounting to around $20 billion (2.75 per cent of annual household disposable income) to low and middle-income households between December and May.[67]

2.69 The committee asked if the Governor saw consumer behaviour changing in the recovery and whether households would go back to the high consumption levels seen before September 2008. The Governor responded:

> If you looked over a five-year horizon, I would expect that it would be a little surprising if the process of gearing up a low savings rate et cetera, which we saw for some years, were such a prominent feature. [68]

2.70 The Governor suggested that the trend would be towards more savings and that this trend may have already been developing. The Governor stated:

> We are already in a period with an adjustment towards less gearing up, a bit more saving, a little bit more thrift. I suspect that was already coming. I would think that we might expect a little bit more of that in the future. You cannot be sure, of course, but that would be my guess.[69]

2.71 The committee raised the question of how the current situation of rising unemployment coupled with reduced working hours will feature in the Bank's future decisions on monetary policy. The Governor noted in his opening statement that following the 2008 financial crisis the RBA, 'aggressively eased monetary policy, delivering the largest reduction in debt servicing for indebted households in modern times.'[70] The Governor further referred to the August Statement on Monetary Policy and pointed

66 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 36.

67 RBA, *Statement on Monetary Policy*, 6 August 2009, p. 37.

68 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 29.

69 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 29.

70 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 3.

out that the debt servicing level for mortgages has fallen by four percentage points of income since mid-2008. The Governor reminded the committee that the reduction in working hours is factored into the calculation of the debt servicing level.[71]

2.72 The Governor said that the capacity of households to keep servicing debt during the current employment climate remains good. The Governor stated:

> I think we would have to say that more people remain in jobs today than most of us thought would be the case six months ago and they are paying lower interest rates. So, not surprisingly, the capacity to keep servicing those loans has actually remained quite good.[72]

2.73 The Governor further explained that the current situation of reduced working hours is preferable to a situation in which businesses shed jobs because households are better able to service debt than if those people had lost their jobs altogether. The Governor stated that:

> The decline in hours versus unemployment actually helps this, I think, because I do not think there is much doubt that the single biggest problem that people would have in servicing a loan obligation of any kind is going to be if they lose their job. If their hours are reduced and the income is reduced but there is still an income coming, that is a much better situation than the loss of the income.[73]

2.74 Looking forward, the Governor predicted that some of the strength in household spending may lesson as the temporary effects of the fiscal stimulus package decrease.[74] Overall however the Governor forecast that household wealth and the impact of low interest rates are likely to be supportive of demand in the period ahead.[75]

The Payments System Board

2.75 The Payments System Board has responsibility for determining the Reserve Bank's payments system policy. The *Reserve Bank Act 1959* states

71 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 9.
72 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 7.
73 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 7.
74 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 6.
75 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 4.

that the Board must exercise this responsibility in a way that will best contribute to:

- controlling risk in the financial system;
- promoting the efficiency of the payments system; and
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.

2.76 The Payments System Board has presided over a significant reform agenda. The committee requested that the Governor outline the key reforms to date and key decisions that are outstanding that remain to be made. The Governor began by explaining the Board's work on card system interchange fees.

> There is a long amount of work done on card system interchange fees—a very bitter battle fought—and the result of all that was that we brought interchange fees down to 50 basis points. We did a number of other things which basically enabled more merchant choice in what merchants accept and which caused the consumers to face the price of the benefits they are getting in terms of points and so on.[76]

2.77 Following the Board's work on card system interchange fees, the Governor then outlined the Board's work on ATM interchange fees:

> There has been another set of changes, which were just coming in last time we met, on ATMs. The result of that has been that, at most institutions, foreign fees have disappeared. The owner of the ATM charges you, if they wish to, to use the machine. As far as I can see, that reform has worked quite well. Many people can actually get a cheaper transaction now.[77]

2.78 The Governor further explained the Board's work on EFTPOS arrangements:

> We have been trying to press the institutions which have stakes in the EFTPOS arrangements to update both the technical architecture of that system and its governance arrangements, and there is some progress being made there; it is not quite as quick as I had hoped but nonetheless progress is being made.[78]

76 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 32.

77 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 32.

78 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 33.

2.79 Finally, Assistant Governor Lowe further explained the Board's role in the international payments system:

> In the wholesale part, a very big issue globally is the use of central counterparties and central settlement facilities to try to reduce systemic risk. The US Federal Reserve just last week put out a number of proposals in that area. That is another general area of the Payments System Board's responsibility and I think it is going to be a focus over the next year or so as people look at how the international financial architecture can be reformed to give greater stability when institutions get into trouble, and the use of central counterparties is clearly going to play a role there.[79]

2.80 The Payment System Board had indicated in September 2008 that it would be prepared to step back from interchange regulation if industry participants took sufficient steps to reduce the risk that interchange fees would rise in the absence of regulation.[80]

2.81 On 26 August 2009 the Payments System Board announced that the conditions for the removal of interchange regulation had not been met. The Board stated that, 'although progress has been made… it is not yet sufficient to warrant a decision to step back from interchange regulation.'[81] As such the Board concluded that it was not in the public interest to remove interchange regulation at this time but stated, 'These matters will remain under review, and the Board is prepared to re-open consideration of the regulations in light of industry developments.'[82]

Conclusions

2.82 The global and Australian economies are showing signs of having reached a turning point towards recovery.

2.83 The pace of global economic recovery over the next few years is expected to be relatively subdued, especially in larger advanced economies. The Australian economy has performed better than forecast at the beginning of the year and is projected to gradually strengthen through 2010 and 2011, showing better growth outcomes than other advanced countries.

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79 Mr G Stevens, Governor of the RBA, *Transcript*, 14 August 2009, p. 33.

80 RBA, *Media Release: Payments System Reform*, 26 August 2009, http://www.rba.gov.au/MediaReleases/2009/mr-09-18.html

81 RBA, *Media Release: Payments System Reform*, 26 August 2009, http://www.rba.gov.au/MediaReleases/2009/mr-09-18.html

82 RBA, *Media Release: Payments System Reform*, 26 August 2009, http://www.rba.gov.au/MediaReleases/2009/mr-09-18.html

2.84 Several factors have contributed to a return to growth in the Australian economy, namely: exposure to strong demand from China and India for Australian resource exports; resilient consumer, business and public demand resulting from Government stimulus measures; and a partial recovery from drought conditions in the agricultural sector.

2.85 Despite the move towards recovery, problems in certain sectors of the economy remain. Specific challenges include, but are not limited to, the undersupply of affordable dwellings nationally and chronic youth unemployment in particular regions.

Craig Thomson MP
Chair
22 October 2009

A

Appendix A — Hearing, briefing, and witnesses

Public hearing

Friday, 14 August 2009 – Canberra

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Mr Ric Battellino, Deputy Governor
Dr Philip Lowe, Assistant Governor (Financial System)

Private briefing

Thursday, 13 August 2009 – Canberra

Mr Alan Oster, Group Chief Economist, National Australia Bank

B

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

The Treasurer and the Governor of the Reserve Bank

6 December 2007

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board, and the Government on key aspects of Australia's monetary policy framework.

Since the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework. Since 1996, this framework has been formalised in a Statement on the Conduct of Monetary Policy.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, it is appropriate and timely for the Governor, and the Treasurer on behalf of the new Government, to outline their mutual understanding of the operation of monetary policy in Australia.

This statement should continue to foster a better understanding, both in Australia and overseas, 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.

Relationship between the Reserve Bank and the Government

The *Reserve Bank Act 1959* (the Act) gives the Reserve Bank Board the power to determine the Reserve Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Reserve Bank Board.

The Government recognises the independence of the Reserve Bank and its responsibility for monetary policy matters and will respect the Reserve Bank's independence as provided by statute.

The Government will implement two new initiatives to further enhance the Reserve Bank's independence.

The positions of the Governor and Deputy Governor will have their level of statutory independence raised to be equal to that of the Commissioner of Taxation and the Australian Statistician. As such, their appointments will be made by the Governor-General in Council, and could be terminated only with the approval of each House of the Parliament in the same session of Parliament.

The Secretary to the Treasury and the Governor will maintain a register of eminent candidates of the highest integrity from which the Treasurer will make new appointments to the Reserve Bank Board. This procedure removes the potential for political considerations in the appointment process and ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Reserve Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Reserve Bank's responsibility for monetary policy, the Act provides that the Reserve Bank Board shall, from time to time, inform the Government of the Reserve Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time.

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.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed of economic policy as a whole. These objectives allow the Reserve Bank Board to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Reserve Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.

Since the adoption of inflation targeting in the early 1990s inflation has averaged around the midpoint of the inflation target band. The Governor takes this opportunity to express his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates that it endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and Accountability

Monetary policy needs to be conducted in an open and forward-looking way. A forward-looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Reserve Bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. Changes in monetary policy and related reasons are clearly announced and explained. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses, its quarterly statements on monetary policy and monthly bulletins, have been crucial in promoting increased understanding of the conduct of monetary policy. The Reserve Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of making himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The Governor has announced that the Reserve Bank Board will release a statement explaining the reasons behind its decision on monetary policy following each meeting, irrespective of whether there is a change in the cash rate target. This statement will be made on the afternoon of the day of each Board meeting (rather than the morning of the following day), with the minutes of the Board meeting being released publicly as soon as possible after the meeting.

The Governor has also indicated that the Reserve Bank will continue to extend the scope of the economic forecasts in its quarterly statement on monetary policy to enhance public understanding of the conduct of monetary policy.

The Treasurer expresses support for these arrangements, which bring the transparency and accountability of the Reserve Bank's conduct of monetary policy into line with international best practice, further enhancing the public's confidence in the independence and integrity of the monetary policy process.

C

Appendix C — Glossary of terms

Australian Competition and Consumer Commission (ACCC). A Commonwealth statutory authority responsible for ensuring compliance with the *Trade Practices Act 1974* and the provisions of the Conduct Code and for administering the *Prices Surveillance Act 1983*. The Commission's consumer protection work complements that of State and Territory consumer affairs agencies.

Australian Payments Clearing Association Limited (APCA). A public company owned by banks, building societies and credit unions which has specific accountability for key parts of the Australian payments system, particularly payments clearing operations.

Australian Prudential Regulation Authority (APRA). APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

Australian Securities and Investments Commission (ASIC). One of three Australian Government bodies (the others being the Australian Prudential Regulation Authority and the Reserve Bank of Australia) that regulates financial services. ASIC is the national regulator of Australia's companies. ASIC has responsibility for market protection and consumer integrity issues across the financial system.

accrual accounting. Revenues and expenses are recorded as they are earned or incurred, regardless of whether cash has been received or disbursed. For example, sales on credit would be recognised as revenue, even though the debt may not be settled for some time.

acquirer. An institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers.

average weekly earnings. Average gross (before tax) earnings of employees.

average weekly ordinary time earnings (AWOTE). Weekly earnings attributed to award, standard or agreed hours of work.

average weekly total earnings. Weekly ordinary time earnings plus weekly overtime earnings.

balance on current account. The difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

bankruptcies. Bankruptcies and Administration Orders under Parts IV and XI of the Bankruptcy Act.

basis point. A basis point is 1/100th of 1 percent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

BPAY. BPAY is a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

business investment. Private gross fixed capital formation for machinery and equipment; non-dwelling construction; livestock; and intangible fixed assets.

card issuer. An institution that provides its customers with debit or credit cards.

cash rate (interbank overnight). Broadly defined, the term cash rate is used to denote the interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis. The Reserve Bank of Australia uses a narrower definition of the cash rate as an operational target for the implementation of monetary policy. The Reserve Bank of Australia's measure of the cash rate is the interest rate which banks pay or charge to borrow funds from or lend funds to other banks on an overnight unsecured basis. This measure is also known as the interbank overnight rate. The Reserve Bank of Australia calculates and publishes this cash rate each day on the basis of data collected directly from banks. This measure of the cash rate has been published by the Reserve Bank of Australia since June 1998.

cash rate target. As in most developed countries, the stance of monetary policy in Australia is expressed in terms of a target for an overnight interest rate. The rate used by the Reserve Bank of Australia is the cash rate (also known as the interbank overnight rate). When the Reserve Bank Board decides that a change in monetary policy should occur, it specifies a new target for the cash rate. A decision to ease policy is reflected in a new lower target for the cash rate, while a decision to tighten policy is reflected in a higher target.

charge card. A charge card is a card whose holder has been granted a non-revolving credit line enabling the holder to make purchases and possibly make cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.

consumer price index. A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

collateralised debt obligations. Collateralised debt obligations (CDOs) are securities that are exposed to the credit risk of a number of corporate borrowers. In the simplest form of a CDO, this credit risk exposure is generated in the same way as for any asset-backed security (ABS): the CDO is backed by outright holdings of corporate debt, such as corporate bonds and corporate loans. Increasingly, however, the exposure to corporate credit risk is synthesised through the use of credit derivatives. Unlike other forms of ABS, where the collateral pools usually consist of loans with broadly similar characteristics, CDO reference pools are typically quite heterogeneous, with exposures to a variety of borrower types and credit ratings and across a number of countries. A CDO will usually have exposures to between 50 and 200 bonds or large corporate loans, or up to 2,000 loans to small and medium-sized businesses.

The simplest forms of CDOs are known as ‘cash' or ‘vanilla' CDOs, and are similar to other forms of ABS. A special purpose vehicle buys loans and securities from financial institutions and other market participants, and funds these acquisitions by selling securities to investors. The manager of the CDO vehicle will usually deduct fees and expenses from the interest income received from the assets in the collateral pool, with the remainder used to make regular coupon payments to investors. The term to maturity of the loans and bonds in the collateral pool will determine the maturity of the CDO securities sold to investors.

credit card. A credit card is a card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period or in part, with the balance taken as extended credit. Interest may be charged on the transaction amounts from the date of each transaction or only on the extended credit where the credit granted has not been settled in full.

debit card. A debit card is a card that enables the holder to access funds in a deposit account at an authorised deposit-taking institution.

derivative. A financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options.

employed persons. Persons aged 15 and over who, during a period of one week, worked for one hour or more for pay or worked for one hour or more without pay in a family business or on a family farm.

G-10. Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and USA; plus Bank for International Settlements (BIS), European Commission, International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development (OECD). It was formed in conjunction with the establishment of the General Arrangements to Borrow, under which members agreed to make resources available to the IMF.

G-20. Group of Twenty Forum: Members are finance ministers or central bankers from - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK and US; plus representatives of the IMF, European Union and World Bank. The G-20 aims to broaden the dialogue on key economic and financial policy issues among systemically significant economies, and promote co-operation to achieve stable and sustainable world economic growth.

G-22. Group of Twenty-two. The G-22's aim was to advance issues related to the global financial architecture. It operated through three Working Parties - on Transparency and Accountability, International Financial Crises, and Strengthening Financial Systems. The group made its recommendations in 1998, and its work has since been taken up in other forums.

G-7. Group of Seven countries: Canada, France, Germany, Italy, Japan, UK and USA. The G-7 Summit deals with issues covering macroeconomic management, international trade, international financial architecture, relations with developing countries, and other global issues.

G-8. Group of Eight countries: G-7 countries and Russia.

gross domestic product. The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production but before deducting for depreciation.

gross domestic product—chain volume measure. Also known as *real GDP*, this is a measure used to indicate change in the actual quantity of goods and services produced. Economic growth is defined as a situation in which real GDP is rising.

gross domestic product at factor cost. Gross domestic product less the excess of indirect taxes over subsidies.

gross foreign debt. All non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia.

household debt ratio. The amount of household debt at the end of a quarter expressed as a proportion of annual household gross disposable income.

household gross disposable income. The amount of income that households have available for spending after deducting any taxes paid, interest payments and transfers overseas.

household net disposable income. Household gross disposable income less depreciation of household capital assets.

household saving ratio. The ratio of household income saved to household net disposable income.

housing loan interest rate. The variable rate quoted by banks for loans to owner-occupiers.

implicit price deflator for non-farm gross domestic product. A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.

index of commodity prices. A Reserve Bank of Australia-compiled index (based 2001/02=100) which provides a measure of price movements in rural and non-rural (including base metals) commodities in Australian Dollars (AUD), Special Drawing Rights (SDR) and United States Dollars (USD).

inflation. A measure of the change (increase) in the general level of prices.

inflation target. A tool to guide monetary policy expressed as a preferred range or figure for the rate of increase in prices over a period. In Australia, the inflation target is between 2 and 3 per cent per annum on average over the course of the business cycle.

interchange fee. A fee paid between card issuers and acquirers when cardholders make transactions.

interest rate. The term used to describe the cost of borrowing money or the return to the owner of the funds which are invested or lent out. It is usually expressed as a percent per annum of the amount of money borrowed, lent or invested.

labour force. The employed plus the unemployed.

labour force participation rate. The number of persons in the labour force expressed as a percentage of the civilian population aged 15 years and over.

labour productivity. Gross domestic product (chain volume measure) per hour worked in the market sector.

long-term unemployed. Persons unemployed for a period of 52 weeks or more.

macroeconomy. The economy looked at as a whole or in terms of major components measured by aggregates such as gross domestic product, the balance of payments and related links, in the context of the national economy. This contrasts with microeconomics which focuses upon specific firms or industries.

market sector. Five industries are excluded from the market sector because their outputs are not marketed. These industries are: property and business services; government administration and defence; education; health and community services; and personal and other services.

monetary policy. The setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

natural increase. Excess of live births over deaths.

net foreign debt. Gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

net overseas migration. Net permanent and long-term overseas migration plus an adjustment for the net effect of 'category jumping'.

non-farm gross domestic product. Gross domestic product less that part which derives from agricultural production and services to agriculture.

overseas visitors. Visitors from overseas who intend to stay in Australia for less than 12 months.

prime interest rate. The average rate charged by the banks to large businesses for term and overdraft facilities.

profits share. Gross operating surplus (the excess of gross output over costs incurred in producing that output) of all financial and non-financial corporate trading enterprises as a percentage of gross domestic product at factor cost.

real average weekly earnings. Average weekly earnings adjusted for inflation as measured by the Consumer Price Index.

real prime interest rate. The prime interest rate discounted for inflation as measured by the Consumer Price Index.

seasonally adjusted estimates. Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

terms of trade. The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is to divide the implicit price deflator for exports by the implicit price deflator for imports.

trade weighted index. A measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners.

turnover. Includes retail sales; wholesale sales; takings from repairs, meals and hiring of goods; commissions from agency activity; and net takings from gaming machines. From July 2000, turnover includes the Goods and Services Tax.

unemployed persons. Persons aged 15 and over who, during a period of one week, were not employed but had actively looked for work in the previous four weeks and were available to start work.

unemployment rate. The number of unemployed persons expressed as a percentage of the labour force.

wage price index. A measure of change in the price of labour (i.e. wages, salaries and overtime) unaffected by changes in the quality or quantity of work performed.

wages share. Wages, salaries and supplements (the total value of income from labour) as a percentage of gross domestic product at factor cost.

west texas intermediate. A type of crude oil used as a benchmark in oil pricing and the underlying commodity of New York Mercantile Exchange's oil futures contracts.

youth unemployment. Number of 15–19 year olds looking for full-time work.

youth unemployment rate. Number of 15–19 year olds looking for full-time work expressed as a percentage of the full-time labour force in the same age group.

Source: Parliamentary Library and Reserve Bank of Australia