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Review of the Reserve Bank of Australia Annual Report 2010 (Third Report)

House of Representatives
Standing Committee on Economics

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Chair's foreword

Australia continues to experience favourable conditions for future growth, economic stability and monetary policy. As the Committee has heard from the Reserve Bank, Australia enjoys extraordinarily good economic conditions, across a range of key areas.

The Australian economy demonstrated resilience through its swift recovery from the effects of various natural disasters early in the year, such as Cyclone Yasi and the Queensland floods. Though production recovered more slowly than first expected, the Reserve Bank's expectations about the limited and temporary effects of the disasters on domestic prices has been vindicated.

Our terms of trade remain at an all high time high, and unemployment remains low by historical standards. Inflation remains within the parameters of the long-established policy of inflation targeting and looks set to remain under control for the foreseeable future. In contrast to many leading economies, our banking sector is sound and does not pose concerns about liquidity, solvency and the reliability of the credit system that plague some international markets.

The soundness and strength of our national situation is evident from the international recognition it receives: our sovereign credit position is in the topmost tier of the international market. However, the retail sector is under pressure because of increased caution by Australian consumers. This caution underpins the financial resilience of household balance sheets and marks a return to higher rates of savings.

While there are concerns about the broader global economic outlook, it is undeniable that the Australian economy is in a strong condition to meet the challenges 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 26 August 2011.

Julie Owens MP

Chair

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Membership of the Committee

Chair	Ms Julie Owens MP (from 24 August 2011) Mr Craig Thomson MP (until 23 August 2011)
Deputy Chair	Ms Kelly O'Dwyer MP (from 12 September 2011) Mr Steven Ciobo MP (until 11 September 2011)
Members	Mr Scott Buchholz MP Mr Steve Ciobo MP (until 13 September 2011) Mr Stephen Jones MP Dr Andrew Leigh MP Mr Tony Smith MP (from 13 September 2011) Mr Craig Thomson MP
Supplementary Member	Mr Adam Bandt MP

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Mr David Monk
Research Officer	Dr Phillip Hilton
Administrative Officer	Ms Natasha Petrović

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

CPI	Consumer Price Index
GDP	Gross Domestic Product
IMF	International Monetary Fund
RBA	Reserve Bank of Australia

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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 appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *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 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.
>
> The Treasurer expresses support for the continuation of these arrangements, through which the transparency and accountability of the Reserve Bank's conduct of monetary policy are in line with international best practice. These arrangements enhance the

> public's confidence in the independence and integrity of the monetary policy process.[1]

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

Scope and conduct of the review

1.4 The third public hearing of the committee with the RBA during the 43rd Parliament was held in Melbourne on 26 August 2011.

1.5 The audio 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 Craig James, Chief Economist, CommSec. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr James'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 Eltham College and Trinity Grammar School.

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 Reserve Bank of Australia, *Statement on the Conduct of Monetary Policy*, 30 September 2010.

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

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]

Next public hearing with the Reserve Bank of Australia

1.11 The committee will conduct the next public hearing with the RBA on 24 February 2012 in Sydney. More details will be circulated in the weeks leading up to the hearing.

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

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Monetary policy and other issues

Overview

2.1 In early 2011 Australia experienced a series of natural disasters, the Queensland floods, Cyclone Yasi and serious storms off the coast of Western Australia which disrupted iron ore exports. At the time the Reserve Bank of Australia (RBA) expected that as a result of these events, economic activity during the March quarter would be weaker than previously expected, and that a recovery would set in by the middle of the year.[1] It was also thought that the rebuilding effort would provide a mild stimulus to demand from the second half of the year, especially in Queensland. The bank also expected a large effect on the price of food, due to crop losses. The bank's position was that the effects of these would all be temporary and that there were no immediate implications for monetary policy.[2]

2.2 These expectations have been largely vindicated, though there have been further developments that complicated matters. As predicted, GDP was weak in the March quarter, due to a fall in coal and iron production that exceeded a modest rise in output throughout the rest of the economy. The output of iron ore has rebound, while the economic disruption to Queensland in general has abated. [3]

2.3 However, the business of draining the coal pits has taken longer than initially expected. As a result, Queensland has so far only recovered about two-thirds of its coal output. A complete recovery is not expected until

1 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

3 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

next year. The delay in returning to coal production levels prior to the natural disasters has been large enough to exert a material effect on forecasts for GDP. [4]

2.4 In addition, unexpected developments in the global economy such as the Japanese earthquake had a significant effect on global manufacturing production and sales, including in Australia's motor vehicle sector. This pressure on economic activity was augmented by the increase in energy prices in the first half of 2011, as well as by uncertainty over public debt in a range of major countries and the ensuing turmoil in equity markets.[5]

2.5 The global picture can be summed up simply enough: equity prices in most markets around the world are anything from 15 to 25 per cent below their recent highs, yields on long-term US securities and core European ones are at a historically low level. The price of gold and currencies perceived to be safe has soared.[6]

2.6 The effect on Australia has been to lower equity prices, but other Australian markets have travelled well. Funding costs have declined, which has resulted in lower costs of fixed rate mortgages. Major banks are now being offered substantial US dollar funding from offshore markets, while their reliance on such sources is falling due to a large increase in deposit funding at home and slower growth in balance sheets.[7]

2.7 The exchange rate has fallen since its peak in mid 2011, but it remains at historically high levels. Prices for selected commodities have fallen a bit, but not slumped. Prices for major Australian commodities remain quite high.[8]

2.8 The Chinese economy continues to grow. Inflation rates across Asia have risen in the past six months. The critical question for Asian countries is whether enough has been done to contain the inflation pressure, which does look to have spread beyond initial rises in food and energy prices.[9]

2.9 Australia's terms of trade remain very high. Investment in the resources sector is very strong. RBA liaison work suggests that, beyond the benefits being experienced by equipment hire, engineering, surveying and consulting firms, a range of businesses (i.e. suppliers of modular housing,

4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.
5 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

lab services and training of semiskilled, trade and other workers) share the stimulus that is flowing through the minerals sector.[10]

2.10 Nonetheless, the terms of trade and resultant high Australian dollar coincide with a popular mood of uncertainty and anxiety which is in turn fuelling changes in household behaviour. The Governor stated:

> ... we have seen a significant change in household behaviour. There was a lengthy period in which households saved progressively less out of current income, increased their leverage and enjoyed a sense of rising prosperity from the increase in asset values. That was most likely a one-time, if rather drawn out, adjustment to a number of important factors. It is understandable that it occurred. It should be equally understandable that it was not going to continue like that indefinitely. The new normal, so-called, which is actually the old normal, is where households save a non-trivial fraction of current income and keep their debt levels or their growth in debt levels more in line with growth of income.[11]

2.11 The Governor advised the committee that Australia appeared to be adapting to this situation quite fast and that, given the recent financial turmoil, it would not be surprising if Australians retained a degree of caution for some time. The Governor's assessment of Australia's present condition was optimistic and he concluded his introductory testimony by stating that:

> In summary, there is a heightened degree of uncertainty at present...There are major challenges to the global economy and there are significant forces at work in the Australian economy. But, at this point in time, our terms of trade are very high while our unemployment rate remains low. Inflation bears careful watching, but I think we can keep it under control. Our banks are strong, our currency is sound and our sovereign credit position is in the international top tier. Consumer caution, while certainly making life hard for retailers, is building resilience in household balance sheets. And corporate balance sheets remain in quite good shape. If we are entering another period of weaker international conditions, then I think that is a pretty good starting point from which to do so.[12]

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 3.

Forecasts for the economy

Forecasts for the global economy

2.12 The global economy continues to expand, though the rate of growth has begun to slow. This slow-down reflects supply-chain difficulties resultant from the Japanese earthquake. The International Monetary Fund's (IMF) central forecast for 2011 and 2012 is for above-average growth across the world economy. The IMF also expects growth in Australia's principal trading partners will be well above average.[13] Growth in China remains high, while growth in the rest of Asia (with the exception of Japan) remains substantial. This growth has sustained high prices for commodities, which in turn has had a distinctly inflationary effect.

2.13 The global economy faces risks from sovereign debt problems in the United States and Europe. In the US, net government debt is at its highest level since 1955.[14] The RBA noted that 'notwithstanding the recent agreement to reduce government spending in conjunction with raising the debt ceiling, public debt in the United States is forecast to continue to rise as a share of GDP for some time yet.'[15]

2.14 Conditions vary greatly across Europe.[16] In northern Europe, Germany's output now exceeds pre-crisis levels. Output has recovered in France and the Netherlands, while growth in the United Kingdom is expected to pick up. Elsewhere, things are not as good: in Italy and Spain the recovery is less advanced than in the leading economies, while activity is depressed in Greece, Ireland and Portugal.[17] While the EU has provided financial assistance to countries in need, further structural reform will be needed.

2.15 Though there has been some fluctuation, global commodity prices remain high by historic standards. The IMF All Primary Commodities has increased by around 25 per cent since mid 2010. This has been possible because of demand from Asia. Global food prices have fallen recently, but remain higher than they were at their peak in 2008. This is fuelled by rising demand in developing countries, not least by changes in consumer references towards higher protein foods.[18] The price of Australian wool is

13 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 7.

14 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

15 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

16 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

17 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 3.

18 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

now 75 per cent higher than a year ago which is caused by high demand from China and the Australian sheep flock being around its lowest level since early last century.[19]

Forecasts for the Australian economy

2.16 The RBA advised the committee that it expects that the year-ended CPI inflation rate will probably remain well above three per cent in the September quarter. From then on, it will decline, as the combined effect of Cyclone Yasi and the Queensland floods on food prices weakens.

Table 1 RBA Output growth and inflation forecasts, year-ended (a)

	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013
GDP	2.7	1¼	3¼	4½	3¾	3¾	3¾
Non-farm GDP	2.2	1	3¼	4½	3¾	3¾	3¾
CPI	2.7	3.6	3½	2½	3½	3¾	3¼
Underlying inflation	2¼	2¾	3¼	3	3¼	3¼	3¼
CPI inflation excl carbon price	2.7	3.6	3½	2½	3	3	3¼
Underlying inflation excl carbon price)	2¼	2¾	3¼	3	3	3	3¼

(a) Technical assumptions include A$ at US$1.00, TWI at 74, and WTI crude oil price at US$87 per barrel and Tapis crude oil price at US$90 per barrel. Sources: ABS; RBA

Source *Reserve Bank of Australia, Statement on Monetary Policy, August 2011, p.73.*

Table 2 RBA Output growth and inflation forecasts, year-average (a)

	2010	2010/11	2011	2011/12	2012	2012/13	2013
GDP growth	2.7	1¾	2	4	4½	3¾	3¾

(a) Technical assumptions include A$ at US$1.00, TWI at 74, and WTI crude oil price at US$87 per barrel and Tapis crude oil price at US$90 per barrel. Sources: ABS; RBA

Source *Reserve Bank of Australia, Statement on Monetary Policy, August 2011, p.73.*

2.17 Growth for 2011 has been revised downwards since the May *Statement*. This is the consequence of weaker recovery in coal production and a fall in consumer spending. The medium-term outlook is characterised by the role of resources-sector investment and growth in resource exports.

2.18 The RBA noted that longer term forecasting needed to engage with the underlying issues that drive economic growth, in particular productivity. The bank advises that:

19 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

> From a longer-term perspective, an important influence on both costs and GDP growth is the rate of improvement in productivity. Since around the mid 2000s, the growth in output has been accounted for by growth in factors of production. The slower productivity growth has been offset by the rise in the terms of trade, so that it has not led to a slowdown in the growth of real incomes in Australia. With the terms of trade expected to decline somewhat over the next few years as additional global commodity supply comes on line, a return to faster rates of productivity growth is likely to be required if living standards are to continue to rise at the average rate of the past two decades.[20]

Budget/fiscal stimulus

2.19 The committee was interested in whether there was an effective balance between fiscal and monetary policy. In particular, the Governor was asked on how critical a federal budget surplus is and its impact on monetary settings.[21]

2.20 The Governor responded by explaining that monetary policy was made in response to developments, which may work to one or other result, but essentially it is the government's responsibility to set fiscal policy. The RBA does not pre-empt the success or failure of budget measures, but responds to evidence of what effect they have had on economic activity.

2.21 Pressed further on his views as to what would be the best fiscal settings to ensure that there is not undue upward pressure on demand, the Governor insisted that this was not a straightforward question, as an answer would involve a range of considerations, including the exchange rate.[22] The Governor stated:

> I think the key issues on the fiscal side are making sure we keep sound public finances over the medium term. You have to go back to balance and surplus, obviously, to do that. That has to be done...There were discretionary measures at the height of the crisis. In a crisis of that nature, that is fine. I think, though, that, absent crisis conditions, essentially devoting the fiscal side to issues of good structure of taxation, efficiency et cetera and sound

20 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

21 *Transcript*, 26 August 2011, p. 7.

22 *Transcript*, 26 August 2011, p. 7.

public finances in the long run, which has been the approach historically, is a good approach in normal times.[23]

Banking sector/savings/debt

2.22 In his opening remarks to the committee, the Governor noted 'that we have seen a significant change in household behaviour', namely a sustained rise in the rate of household savings.[24] He characterised this as a reversion to an old norm, whereby households save a greater than nominal proportion of their income and restrain the growth of debt. This observation was relevant to questions that had been raised by the committee at previous hearings, namely the issue of what might constitute a normal rate of savings. The committee again pursued this matter, asking the Governor what a normal savings rate would be. The Governor stated:

> It is hard to be doctrinaire about the optimal rate being X in theory. We should also take care with building very strong hypotheses on the saving rate per se, because it is inevitably not a very well measured aggregate—it is the residual... With that caveat in mind, I think what was not normal was for a saving rate to be zero in gross terms or negative in net terms. That is very unusual, historically. As to where it is now: I am not sure whether this is optimal, but it seems much more like saving performance that we would have observed through much of the post-war period. So in that sense it is more normal than what we were seeing.[25]

2.23 Picking up on a remark by the Governor that 'the rise in the rate of household savings is the biggest adjustment of its kind in the history of the quarterly national accounts', the committee asked the Governor to identify the positives and negatives inherent in this situation.[26] The Governor replied:

> The bad side is if you are a retailer coming off that 15-year period of gearing up, with falling savings and higher spending...[the good side is that] at some point people reach a stage where they are feeling, 'I don't really want more debt; maybe I really ought to be

23 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 7.
24 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.
26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.

> thinking about some saving out of current income for the future.' ...that is going to leave household finances in a stronger position. That is good because someday, if there is a downturn, you do not want households to be excessively exposed in terms of their leverage when there is an adverse shock to income...we are [also] having a very substantial investment pick-up in the economy in aggregate... we have an investment boom; it is actually not a bad thing to have some saving to help fund that. We do not have to fund it all ourselves; we can use the savings of foreigners—that is perfectly sensible.[27]

2.24 The committee was interested in identifying the causes behind the increased caution of Australian household consumers. The Governor referred to a recent speech that he had delivered to the Anika Foundation which had dealt with a number of the committee’s concerns in a historical context.[28] He went on to explain that Australia had gone through a long period in which growth of spending exceeded growth of income every year on average by about a percentage point. Savings fell, leverage increased, housing prices rose, wealth rose – all because of the combined effects of financial liberalisation, an increased willingness of Australian banks to lend to households which were undergeared by international standards, a big decline in nominal interest rates and a fall in inflation from an average of eight percent to an average of two or three. This was compounded by international economic stability which provided low inflation, positive supply-side surprises and so on. In the Governor’s words:

> That is a perfect environment for people to think it is sensible to have more debt: 'I can afford it, the bank wants to give it to me and so on.' There is nothing especially wrong with that, but when income and consumption do this sooner or later they are going to go back to parallel, which is roughly what they have done...[29]

2.25 The committee was interested in establishing what Australia needed to do to support further the stability of the financial system. Asked directly by the committee what policy issues need to be addressed, the Governor advised that a great deal of work has already been done internationally to address financial sector stability. The foundation for such stability is more

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27 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.

28 Mr Glenn Stevens, *The Cautious Consumer*, an address to the Anika Foundation Luncheon, Sydney, 26 July, 2011. This is available electronically at: http://www.rba.gov.au/speeches/2011/sp-gov-260711.html

29 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 10.

and better quality capital; the problem had been that large global banks had been very highly leveraged and undercapitalised. The Basel 3 initiatives, which Australia will implement, will address this matter. There is a also a range of work on increasing the strength of financial infrastructure to process the clearance of derivatives and related financial instruments. Work is already underway on this under the auspices of the Council of Financial Regulators. The central issue is whether we ought to mandate central clearing of certain instruments onshore or allow them to be established offshore.

2.26 The Governor elaborated further, explaining 'that the fundamentals ultimately matter most' and these included good prudential supervision, which we have through APRA and ASIC.[30] Summing up the situation of the Australian financial sector in a positive note, the Governor stated:

> [Australian] banks are pretty well capitalised. The consumer balance sheets...are coming into better shape too...while we do not want to say that nothing would bother us, I think that perhaps we have a stronger position than we had a few years back.[31]

Carbon

2.27 The committee was interested in the implications of the carbon pricing mechanism for monetary policy and requested that the Governor explain the possible implications for monetary policy. The Governor explained that the RBA perceived the carbon price as 'a public policy intervention...to achieve a particular outcome', similar to the GST, which raised the price level.[32] The RBA believe that such interventions are not the same thing as regular inflation and that it was not appropriate to tighten monetary policy in response to such things.

2.28 The Governor elaborated further by stating that, 'the key thing will be to make sure that there are not ongoing significantly higher inflation rates resulting from that'.[33] So long as there were not, monetary policy would not have to change. He also stated that 'it is to be hoped that that is the outcome here'.[34]

30 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 26 August 2011, p. 12.
31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 12.
32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.
33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.
34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

2.29 Pressed further by the committee, which referred to claims in the public arena made by third parties about the reputed views of the RBA on the likely impact of the proposed carbon price on the rate of inflation, the Governor dismissed the matter in its entirety:

> What we [the RBA] do not do is get into political debates over particular policies. What we do is keep focused on articulating our expectations and also monitoring actual measures of inflation expectations...Ultimately people will see what the effect is and then it will be clear. It is only another year or so.[35]

Productivity

2.30 The issue of productivity was examined in a variety of different contexts. The committee sought the RBA's opinion on why productivity growth has slowed since the mid 2000s. The Governor answered that productivity growth in Australia had indeed slowed, just as it appears to have done in a number of countries and that the problem was evident in the bulk of Australian industries. He stated that the impetus for productivity gains weakened during good times and that:

> ...the period of maximum focus on productivity-enhancing measures and reforms was really in the period when the banana republic issues were being debated. There was not any alternative; we felt we had to do it and we did do it...the thing we have rarely done is to try to work on improving productivity materially when the terms of trade are high, but if we could do that it would be a fabulous way to take advantage of the opportunities we have.[36]

2.31 The committee was also interested in the Governor's views about the possible relationship between the trimming of productivity growth and variations in the non-accelerating inflation rate of unemployment (NAIRU). The Governor replied that:

> In terms of demand versus supply inflation if you take as your starting point that there has been a material slowdown in productivity—if that is so—that is really saying in a way that the economy's capacity to supply the demand that we want to have is not what it used to be...What businesspeople say to me... is not so much that wages are excessive and indeed at this point in time the

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 19.

> aggregate data on wage growth which is probably fourish, a touch under maybe, is on a par with what we have seen over the years. What people say to me, I cannot verify it obviously, from their individual businesses is that they find it harder to negotiate flexibility. That is something that is said. If that is true that I think is a matter for concern.[37]

2.32 The committee, however, scrutinised the Governor over whether it was sensible to rely on anecdotal evidence in making conclusions about workplace flexibility. It was noted that the Australian workforce has demonstrated considerable flexibility over the last decade and that Australians work more hours in than just about any other OECD country. The Governor responded by saying that he had simply reported back on what he had been told and that: 'I would be the first to say that I do not have a rigorous study which can quantify whether that is material or not'.[38]

Terms of trade/two speed economy

2.33 The committee explored the terms of trade issue, seeking the RBA's advice on the benefits that the favourable terms of trade is bringing to Australians. In particular, the committee sought the RBA's advice on the benefits the mining boom has for other sectors of the economy. The Governor stated:

> National income is higher...about half of that higher terms of trade revenue stays in Australia one way or another, be it through employment or profits that go into people's equity holdings, super funds, revenues to government and so on.[39]

2.34 Dr Lowe expanded on this, explaining that the RBA has researched this issue over the past decade.[40] This research has found that for every dollar of extra revenue Australia receives from the resources sector about 10c is spent on domestic labour, 25c on buying domestic services and imports into the resources sector, somewhere between 15c and 20c goes to the state via royalties or taxation and somewhere between 5c and 10c goes to the domestic holders of the shares of the mining company. Added together,

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37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 8.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 18.

39 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

40 Dr Philip Lowe, Assistant Governor, Economic Group, RBA, *Transcript*, 26 August 2011, p. 5.

somewhere between 50c and 60c of every extra dollar of income that comes into the country is retained by Australians in one form or another.

2.35 The issue of the two-speed economy and regional growth was examined. In particular, the Governor was asked about the impact of monetary policy on regional economies and on industries such as manufacturing?'[41] The Governor explained that:

> ...issues of structural adjustment...are difficult. Some parts of the economy will shrink while others grow....I do not think monetary policy can stop that occurring...We do not have an instrument that can prevent these shifts in the structure of the economy from occurring. I am sorry but I think that is just the reality.[42]

2.36 The committee was also interested in the implications of the two-speed economy for managing inflation. The committee posed the question that if inflation was being driven by that 25 per cent of the economy experiencing a 15 or 16 per cent rate of growth (the resources sector), while the rest of the economy is growing at one per cent, what would be the best tool to curb inflation? [43]

2.37 The Governor dismissed quantitative easing as a solution because this was an easing of policy which would be expected to increase inflation. The Governor went on to explain that were we to look at the 100,000 prices that are in the CPI, mining is not pushing up most of them directly. Instead, there is evidence that accounts for inflation in other sectors, such as utilities. Consequently, the Governor declared that he did not 'accept that all the inflation is in fact coming just out of mining' and that 'were it not for the high exchange rate, I think we would have more of this'.[44]The RBA explained that 'the underlying inflation pressures in the economy are really coming from this combination of relatively weak productivity growth and around average wage growth'.[45] This inflationary pressure has been offset by decline in prices for manufactured goods, many of which are now lower than they were a decade ago.

2.38 The committee was interested in exploring if there was a connection between the mining boom and the increasing gap between rich and poor that has been evident for several decades past. The committee referred to a paper delivered at a recent RBA conference that showed that wage growth

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41 *Transcript*, 26 August 2011, p. 17.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 17.

43 *Transcript*, 26 August 2011, p. 8

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 8.

45 Dr Philip Lowe, Assistant Governor, Economic Group, RBA, *Transcript*, 26 August 2011, p. 8.

over the last decade for the top quintile of wage earners had been twice as fast as for the bottom. In view of this, the Governor was asked whether the RBA targets the average dollar in Australia or the average person.[46]

2.39 The Governor explained that the RBA sought to contain the growth in the CPI to between two and three per cent per annum. In essence, the RBA was attempting to 'preserve the purchasing power of money, and not particularly the purchasing power of the money of the richest or the poorest but the total'.[47] Following further questions about the RBA's mandate concerning growth and full employment and the relative importance of the average person as compared to the average dollar, the Governor stated categorically that:

> My answer to the full employment question would be: I think the bank has fulfilled that side of its mandate, recognising of course that a sustainable unemployment rate ultimately is a function of industrial relations matters, not monetary policy.[48]

Payments system

2.40 The committee sought an update on developments with the payments system.[49] In particular, the committee sought advice on possible concerns about an erosion of competition between the four-party and three-party schemes since the last round of regulation. The Governor replied that it would be premature to provide too much detail on this matter as there is a review occurring.[50] The Governor noted, however, that the Payments System Board was aware of the comparison, and that the four-party schemes make the point that the three-party ones are not subject to the same degree of regulation.

2.41 The Governor also advised that he thought it best if such questions were addressed as part of wider discussion that not only covered interchange

46 *Transcript*, 26 August 2011, pp. 8-9. The paper in question is Jeff Borland's, 'The Australian labour market in the 2000s: The quiet decade', which was presented at the RBA's conference *The Australian Economy in the 2000s*, 15-16 August 2011; the paper is available at http://www.rba.gov.au/publications/confs/2011/borland.pdf.

47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

49 For an accessible introduction to the Australian payments system, see the RBA's web page on this, which is available at: http://www.rba.gov.au/payments-system/about.html.

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

regulation, but also surcharging, which is currently being reviewed by the RBA. The RBA will develop a considered opinion in due course.[51]

2.42 When asked directly if, with the benefit of hindsight, it might have been a mistake to have regulated only part of the market, the Governor replied that he would not draw that conclusion. He noted that there are no interchange fees in the three party schemes, 'so if you are regulating interchange fees there is not one to regulate there.'[52]

2.43 Dr Lowe explained that the relative price of using credit or debit cards has changed, so that consumers are no longer charged when we use a debit card, whereas some consumers had been charged. Consumers are becoming more cautious, in that people now prefer debit over credit, while many of the rewards that consumers used to get from using credit cards have diminished and the cost they pay for using debit cards has disappeared. The purpose of the reforms was to use price signals to get people to make choices based on underlying costs, rather than distortions arising from the interchange system. Summing the effect of the reforms, Dr Lowe noted that 'broadly speaking, that has worked.'[53]

2.44 The committee pursued the issue of how best to manage the payments systems, asking the Governor which option he thought best, more or less regulation? The Governor answered by stating that for less regulation, we would first require evidence that competition within the system has increased, because the payment system board's mandate is efficiency, but also competition. If we could find clear evidence that we have competition between card schemes and between competing payment mechanisms or both, that is the minimum precondition needed for less intrusive regulation. So far, it is not clear that we do see enough competition. In conclusion, the Governor stated that: 'I think if we took our hands off the interchange now the interchange fees would just go back up and we would be back to the situation...that we were trying to move away from.'[54]

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

52 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

53 Dr Philip Lowe, Assistant Governor, Economics Group, RBA, *Transcript*, 26 August 2010, p. 21.

54 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 22.

Governance

RBA executive remuneration

2.45 The committee noted that the Governor and others had made statements about the importance of pay being strongly related to productivity, which in turn had led to public comment on the salaries of Reserve Bank officials.[55] The committee sought the Governor's views on Reserve Bank salaries and the relativities between RBA salaries and other central banks. The Governor stated:

> I am not sure I can help much there. I do not set my own pay. The board set it. They had quite a lengthy process of reviewing it after the system had been in place for many years. They took their decision, and I take what I am given, like anyone else in the country. I am not able to give you the whys and wherefores of whether that was an appropriate decision. I did not take it. I had no involvement in it. [56]

Securency and Note Printing Australia

2.46 At the previous public hearing on 11 February 2011, the RBA was scrutinised on bribery allegations surrounding Securency and Note Printing Australia. At that hearing, the Governor confirmed that the first time the RBA became aware of bribery allegations in relation to the agents of Securency was around May 2009. At the most recent August public hearing, the RBA reconfirmed this advice.[57]

2.47 As part of the current hearing, the committee scrutinised the RBA in detail on the timeline and the actions that were taken by the RBA Board and the Boards of Securency and Note Printing.[58] In particular, it was noted that allegations about Note Printing were made in May 2007. The RBA confirmed that the Board of Note Printing received a paper about the need for stronger policies for agents. The RBA stated:

> So, as a result of that meeting in May [2007], the board of NPA said that there were issues about bad business practices in relation

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55 *Transcript*, 26 August 2011, p. 10.

56 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 10.

57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 12.

58 *Transcript*, 26 August 2011, p. 10.

> to the agents and things like that, so they took some fairly hard decisions. They said, 'Look we want to stop the use of agents.'[59]

2.48 In addition, the RBA advised that the NPA board commissioned an audit into the use of agents. The audit found that the NPA board 'should undertake an investigation to make sure that no Australia laws had been breached.'[60] The NPA board commissioned Freehills to investigate whether any laws had been broken. The RBA reported that 'the investigation concluded that there was no evidence of any Australian laws being broken, and the NPA board at that point drew a line under it.'[61] The committee scrutinised the RBA on this citing an *Age* newspaper article that the audit report contained prima facie evidence of illegal conduct by an agent of a subsidiary. The RBA repeated its advice that an independent legal firm found 'that there was no evidence of any breach of Australian law.'[62]

2.49 The committee sought advice on what measures were taken in relation to agents used by Securency. The RBA advised that an audit in 2007 was done of Securency's use of agents which 'came back as a very sound audit with very few findings.'[63] However, the RBA reported that KPMG undertook 'a very forensic audit' of Securency after allegations were raised in 2009. During this period, Securency also stopped using agents. The RBA stated:

> It was around late 2009. At that point the KPMG audit investigation was still continuing, but they brought to the attention of the Securency board some information which they felt showed that the management had not been honest with the board and had been withholding information from the board. At that point the board of Securency terminated or suspended the management and suspended the use of agents.[64]

2.50 The RBA was asked if KPMG were given the RBA audit and the Freehills report, to which the RBA replied 'yes.'[65] However, after the hearing the RBA sought to clarify this advice and, in a submission dated 29 August 2011, stated:

59 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
60 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
61 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
62 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 15.
63 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 14.
64 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 16.
65 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 15.

> The specifics of the information given to KPMG are as follows: They were given access to all documents of Securency, including the two audit reports undertaken by the RBA's internal audit department. They were also briefed that the recommendations of the NPA audit was that the company should cease the use of agents and were given access to the team that undertook that audit (which was also the team that undertook the Securency audits). KPMG were told of the Freehills report and briefed on its conclusions but, as this was not a document of Securency, they were not given a copy of it.[66]

2.51 The RBA advised that the police have been provided with the audit reports and the Freehills report and 'these are matters before the courts.'

2.52 The committee will have an opportunity to seek an update from the RBA at the next hearing which will be scheduled in February 2012.

66 Reserve Bank of Australia, *Submission 1*, p. 1.

Conclusion

2.53 During a time of widespread uncertainty in global markets and recurrent anxiety about significant portions of the financial sector in many of the most advanced countries, Australia continues to enjoy the fruits of years of sound economic governance, not least of which is its monetary policy and very well regulated banking sector.

2.54 The recovery from Cyclone Yasi and the devastating Queensland floods has begun, albeit at a marginally slower pace thanks to external shocks (such as the Japanese earthquake) and domestic developments (the slower than expected drainage of Queensland coal mines)

2.55 Monetary policy remains on track to meet the goals of its long-standing policy of maintaining inflation within the 2 to 3 per cent band over the medium-term.

Julie Owens MP
Chair
2 November 2011

A

Appendix A — Hearing and submission

Public hearing

Friday, 26 August 2011 – Melbourne

Reserve Bank of Australia

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

Private briefing

Thursday, 25 August 2011 – Canberra

Mr Craig James, Chief Economist, CommSec

Submission

Submission 1	Reserve Bank of Australia

B

Appendix B —*Statement on the conduct of monetary policy*

The Treasurer and the Governor of the Reserve Bank

30 September 2010

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 and central banking 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. The inflation targeting framework has served Australia well and is reaffirmed in the current statement.

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.

This statement also records our common understanding of the Reserve Bank's longstanding responsibility for financial system stability.

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 continue to respect the Reserve Bank's independence as provided by statute.

New appointments to the Reserve Bank Board will be made by the Treasurer from a register of eminent candidates of the highest integrity maintained by the Secretary to the Treasury and the Governor. This procedure 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. The Governor issues a statement immediately after each meeting of the Board, announcing and explaining the Board's monetary policy decision, and minutes of each meeting are issued two weeks later providing background to the Board's deliberations. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its quarterly *Statement on Monetary Policy* and *Bulletin*, 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.

The Treasurer expresses support for the continuation of these arrangements, through which the transparency and accountability of the Reserve Bank's conduct of monetary policy are in line with international best practice. These arrangements enhance the public's confidence in the independence and integrity of the monetary policy process.

Financial Stability

The stability of the financial system is critical to a stable macroeconomic environment. Financial stability is a longstanding responsibility of the Reserve Bank and its Board, and was reconfirmed at the time of significant changes made to Australia's financial regulatory structure in July 1998. These changes included the transfer of responsibility for the supervision of banks to a new integrated regulator, the Australian Prudential Regulation Authority (APRA), and the establishment of the Payments System Board within the Reserve Bank.

The Reserve Bank Board oversees the Bank's work on financial system stability. Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system. It does this in several ways, including through its central position in the financial system and its role in managing and providing liquidity to the system, and through its chairmanship of the Council of Financial Regulators, comprising the Reserve Bank, APRA, the Australian Securities and Investments Commission and Treasury. In addition, the Payments System Board has explicit regulatory authority for payments system stability. In fulfilling these obligations, the Reserve Bank will continue to publish its analysis of financial stability matters through its half-yearly *Financial Stability Review* and will be available to report as appropriate to relevant Parliamentary committees.

The Reserve Bank's mandate to uphold financial stability does not equate to a guarantee of solvency for financial institutions, and the Bank does not see its balance sheet as being available to support insolvent institutions. However, the Reserve Bank's central position in the financial system, and its position as the ultimate provider of liquidity to the system, gives it a key role in financial crisis management. In fulfilling this role, the Reserve Bank will continue to co-ordinate closely with the Government and with the other Council agencies.

The Treasurer expresses support for these arrangements, which served Australia well during the recent international crisis period.

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