The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2012 (First Report)

House of Representatives
Standing Committee on Economics

March 2013
Canberra

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Chair's foreword

Last year the global economy faced some serious downside risks. These included the US fiscal cliff, China's slowdown and instability in the Eurozone. These risks were not fully realised and as the Governor noted 'a truly disastrous outcome was avoided'.

The Governor was generally optimistic about the global economic outlook. World GDP is forecast to grow at 3½ per cent in 2013 before picking up to 4 per cent in 2014. If managed satisfactorily the US economy has a good chance of delivering an upside surprise. The slowdown in China's economy has ended and the medium-term outlook is for a steady pace of growth.

On the downside, the Governor cautioned that Europe still faces immense economic challenges. In the longer term the Governor noted that it was unclear how the global economy would react when countries, like Japan and the United States, tighten monetary policy.

Domestically the economy is slightly weaker than was forecast by the RBA in November 2012. The downwards revision reflects the impact of fiscal consolidation, the high level of the Australian dollar, the expectation that mining investment will peak and weakness in non-mining business investment. However, growth is expected to pick up in 2014.

Growth in Australia's mining sector is predicted to peak towards the end of this year. As a result, there will be some tough structural adjustments in the Australian economy over the years ahead. However, as businesses and governments adapt to the new conditions, productivity in Australia will be further strengthened.

Forecasts continue to embody a gradual recovery in dwelling investment and non-mining business investment. The sentiments of households have improved and consumer demand is expected to increase.

Over the next few quarters underlying inflation is expected to remain at an annual rate of 2½ per cent.

The cash rate has been reduced six times over the last 16 months for a decline of 175 basis points. As a result lending rates have fallen to near historic lows. The Governor indicated that the effects of monetary policy are flowing through the economy with share prices increasing and 'safe assets', such as bonds and bank deposits, decreasing. The Governor confirmed that at present the Board has 'a bias to ease' on rates.

Finally, 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 22 February 2013.

Julie Owens MP
Chair

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Members	Mr Scott Buchholz MP
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	Mr Stephen Jones MP
	Dr Andrew Leigh MP
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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.

1

Introduction

Background

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

1.2 The appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *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

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

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 sixth public hearing of the committee with the RBA during the 43rd Parliament was held in Canberra on 22 February 2013.

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 Professor Warwick McKibbin, Chair in Public Policy, Centre for Applied Macroeconomic Analysis, Crawford School of Public Policy, ANU. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Professor McKibbin's cooperation and assistance.

1.7 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.

1.8 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: <http://www.aph.gov.au/economics>

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

2

Monetary policy and other issues

Overview

2.1 On 5 February 2013 the Reserve Bank of Australia (RBA) decided to hold official interest rates at three per cent. In his statement on the decision, the Governor noted that while growth in the global economy was forecast to be 'a little below average for a time', the 'downside risks appear to have abated'.[1] On the upside, sentiment in the financial markets has continued to improve; the United States has to date avoided a severe fiscal contraction; Europe's financial strains have eased; and growth in China is relatively robust. [2] Of particular benefit to Australia's economy was the firming of some commodity prices, in particular iron ore. In conclusion the Governor stated:

> The Board's view is that with inflation likely to be consistent with the target, and with growth likely to be a little below trend over the coming year, an accommodative stance of monetary is appropriate. The inflation outlook, as assessed at present, would afford scope to ease policy further, should that be necessary to support demand.[3]

2.2 During the hearing on 22 February 2013 to the House of Representatives Standing Committee on Economics, the Governor's forecasts for both the

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1 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see:< http://www.rba.gov.au/media-releases/2013/mr-13-01.html>.

2 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see:< http://www.rba.gov.au/media-releases/2013/mr-13-01.html>.

3 Mr Glenn Stevens, Governor of the RBA, *Media Release: Statement by Glenn Stevens, Governor: Monetary Policy Decision*, see:< http://www.rba.gov.au/media-releases/2013/mr-13-01.html>.

global and Australian economies aligned with the RBA's February 2013 *Statement on Monetary Policy*.

2.3 The Governor commented that he hoped to see monetary policies in the major countries 'get normalised', which referred to winding back quantitative easing and increasing the cash rate.[4] However, he noted that it was unclear how the global economy would react when countries, like Japan and the United States, tighten monetary policy:

> We all understand why we are in this position and why the major countries are doing what they are doing. But it is a very big experiment, in a sense, the full results of which we will not know for quite a long time…[5]

2.4 The Governor commented that the Australian economy was in a period of 'transition' as it moved out of the mining boom. In summary the Governor stated:

> As we go through that period [of transition], the pressures to adapt business models, to contain costs, to increase productivity and to innovate will all remain. But, those adjustments—which are very difficult to make—are nonetheless positive for longer-term economic performance.[6]

2.5 Under questioning from the committee, the Governor reiterated that productivity was on the rise in Australia, and with that would come a rise in economic growth.[7] As the result of structural changes in the economy, the Governor noted:

> … we will be seeing, some rise in productivity, because there is no choice. Businesses that are under pressure in a number of areas will be taking decisions, and that productivity growth will come. It is coming. It is not easy to do; it is very unpleasant and painful.[8]

2.6 During the hearing, the committee probed the Governor on a number of areas of fiscal and monetary policy and their impacts on the economy. The topics discussed included the current cash rate, the high exchange rate, real-time payments, the Reserve Bank Reserve Fund and the net interest margins of the major banks.

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4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 18.
5 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 7.
6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 3.
7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 17.
8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 17.

Forecasts

2.7 As previously noted, downside risks to the global economy last year included instability in the Eurozone, the US fiscal cliff and China's slowdown. These risks were not fully realised and 'a truly disastrous outcome was avoided'. [9] However, the Governor cautioned that Europe faces 'immense challenges, so, as usual, it is important to stress that sentiment remains vulnerable to setbacks'.[10] Despite recent pessimism about the US economy, the Governor postulated that if managed satisfactorily it has 'as good a chance of delivering an upside surprise as a downside one over the period ahead'.[11] The Governor also noted that the 'slowdown in China's economy has come to an end' and that the medium-term outlook is for 'a less hectic pace of growth'.[12]

2.8 According to the February *Statement*, World GDP will grow at 3½ per cent in 2013 before picking up to 4 per cent in 2014.[13]

2.9 The Governor discussed the current policies of quantitative easing in the US and Japan, and transitioning out of a zero cash rate in the future. He noted that the repercussions of future monetary tightening were uncertain:

> What we are seeing is something which, to my knowledge, does not have a historical precedent. We have major central banks, especially the fed and, it would appear, once again, the bank of Japan, in the near future, engaging in substantial purchases of assets, in what has become known colloquially as quantitative easing. The reason they are doing that, as you know, is that they have found the zero lower bound on the short-term rate… I think there will come a time when growth is better and people start to turn their minds to what the next phase in policy is, and it is going to be a difficult calibration task for all of these countries to find how to very gradually unwind this.[14]

2.10 Domestically the economy is slightly weaker than forecast in the November 2012 *Statement*.[15] The downwards revision reflected the impact

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 1.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 1.

11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 1.

12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 1.

13 RBA, *Statement on Monetary Policy*, February 2013, p. 63.

14 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 7.

15 RBA, *Statement on Monetary Policy*, February 2013, p. 3.

of fiscal consolidation, the high level of the Australian dollar, the expectation that mining investment will peak and weakness in non-mining business investment.[16] It is expected that growth will pick up 'a little' in 2014.[17]

2.11 Forecasts continue to embody a gradual recovery in dwelling investment and non-mining business investment.[18] The sentiments of households have improved and consumer demand is expected to increase.[19] The transition out of the peak of the resources boom may not be 'seamless' but it will happen over time. As the Governor stated:

> As we go through that period, the pressures to adapt business models, to contain costs, to increase productivity and to innovate will all remain. But, those adjustments—which are very difficult to make—are nonetheless positive for longer-term economic performance.[20]

2.12 At the hearing the Governor noted that while he expects Australia's terms of trade to decline further over the next few years, 'they will probably be more than 50 per cent higher… than they were on average in the 20th century'.[21] Export volumes will continue to strengthen.

2.13 Over the next few quarters underlying inflation is expected to remain at an annual rate of 2½ per cent.[22]

2.14 The cash rate has been reduced six times over the last 16 months for a decline of 175 basis points. As a result lending rates have 'fallen to be not far from their historic lows'.[23] The effects of monetary policy are flowing through the economy with share prices increasing and 'safe assets', such as bonds and bank deposits, decreasing.[24] When questioned about the future movements in the cash rate, the Governor noted that 'there is a

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16 RBA, *Statement on Monetary Policy*, February 2013, p. 3; Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 2.

17 RBA, *Statement on Monetary Policy*, February 2013, p. 3.

18 RBA, *Statement on Monetary Policy*, February 2013, p. 3; Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 2.

19 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 2.

20 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, pp. 2-3.

21 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 2.

22 RBA, *Statement on Monetary Policy*, February 2013, p. 3.

23 RBA, *Statement on Monetary Policy*, February 2013, p. 3.

24 RBA, *Statement on Monetary Policy*, February 2013, p. 3.

good deal of interest stimulus in the pipeline'.[25] However, he confirmed that the Board had 'a bias to ease'.[26]

2.15 As will be discussed below, on the issue of Australia's exchange rate the Governor indicated that he believed it was 'somewhat overvalued' and that if this was the case the market would bring it down.[27] When questioned on the issue of timing, the Governor cautioned that 'forecasts of exchange rates are probably the worst forecasts in economics'.[28]

2.16 Generally the Governor confirmed that the labour market had softened in 2012, with job vacancies declining, unemployment increasing and labour force participation declining.[29]

Table 1 RBA Output growth and inflation forecasts

		Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014	June 2015
GDP growth		3½	2½	2–3	2-3	2½–3½	2½–3½
Non-farm GDP growth		3½	2¾	2–3	2–3	2½–3½	2½–3½
CPI inflation		2.2	3	2–3	2–3	2–3	2–3
Underlying inflation		2¼	2½	2–3	2–3	2–3	2–3
Year-average							
		2012	**2012/ 2013**	**2013**	**2013/ 2014**	**2014**	**2014/ 2015**
GDP growth		3¾	3	2-3	2–3	2¼–3¼	2½–3½

Technical assumptions include A$ at US$1.03, TWI at 77 and Brent crude oil price at US$133 per barrel.

Source *Reserve Bank of Australia, Statement on Monetary Policy, February 2013, p. 65.*

25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 3.
26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 14.
27 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 22 February 2013, p. 8.
28 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 18.
29 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 2.

Inflation targeting and monetary policy

2.17 During the hearing, the Governor was asked if the RBA should be targeting nominal GDP rather than inflation. The Governor indicated that he was in favour of keeping the current system.[30]

2.18 The *Reserve Bank Act 1959* sets out the powers and policy objectives of the Bank. Broadly, section 10(2) states that it is the Reserve Bank Board's goal to conduct monetary policy that 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 Bank's Annual Report 2012 goes on to state:

> For almost 20 years now, this general mandate has found concrete expression in the form of a medium-term inflation target. Monetary policy aims to keep the rate of consumer price inflation at 2-3 per cent, on average over the cycle.[31]

2.19 The Governor explained how nominal GDP is affected by movements in trade:

> … if you think about nominal GDP in the last several years, we had a huge trade increase, then a big fall, then another big increase, and now we are having a sizeable but not too rapid decline. That swings nominal GDP around a lot. Indeed, a lot of the discussion of the budget and the difficulties of forecasting revenue comes with this variability in nominal GDP. If we had a target to, say, keep nominal GDP growth at six per cent or something, I think we would have found it very difficult to achieve that in that period and we would be swinging the economy around in response to the terms of trade in a way that would be destabilising.[32]

2.20 Secondly, the Governor explained that CPI is one of the most credible means the bank has when explaining its role to the general public: 'What we are trying to do is preserve the value of your money and we measure

30 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.

31 RBA, *Reserve Bank of Australia: Annual Report*, 2012, p. 3.

32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.

that by the CPI'.[33] The Deputy Governor, Dr Lowe, explained the advantage of the current system:

> … it really anchors people's inflation expectations. If you live in this country you know that over time inflation is going to average, roughly, 2½ per cent. That is tremendously useful for people when they are setting wages and when firms are setting prices. They have some certainty about the general level of prices.[34]

The cash rate

2.21 The Governor noted that the current cash rate of 3 per cent is low and that the last time that it was at this level was in response to the 2008/09 financial crisis.[35] The Governor indicated that during the financial crisis it became clear that Australia would not be as adversely affected as 'feared', and he decided it was prudent to return the cash rate to a normal level in the short term.

2.22 The Governor was asked whether he believed the current cash rate could cause distortions in the economy. As the result of a range of factors, including fiscal policy tightening, changed household saving patterns and the high exchange rate, it was the Governor's 'sense' 'that the appropriate interest rate for the economy's circumstances is in fact the pretty low one we have.'[36]

2.23 The Governor confirmed that currently the Bank's position on the cash rate was a 'bias to ease'.[37] In this regard he concluded:

> Rates are low and it seems appropriate that they should be. The statement we made is that, given the inflation outlook, and assuming we are right about that, we would have scope if needed to ease a bit more. That is what we said. I think it is a fair reading of that to say that an easing is more likely than a tightening, and indeed that is what is priced into financial markets as well.[38]

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33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.
34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.
35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 4.
36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 4.
37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 14.
38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 14.

The exchange rate

2.24 The committee asked the Governor whether the Australian dollar is overvalued. Drawing on the Bank's research, the Governor assessed that the Australian dollar was 'somewhat overvalued, though we are not talking by huge amounts'.[39]

2.25 In his opening statement the Governor noted:

> … the exchange rate does remain somewhat higher than one might have expected given the decline in export prices so far observed. That has been a relevant factor in the setting of interest rates. It is not that interest rates are being set to try to achieve a particular outcome on the exchange rate, but they are being set with a recognition of the exchange rates' effects on the economy.[40]

2.26 The Governor discussed the two mechanisms by which the dollar could be lowered: market forces or intervention. On the option of intervention the Governor cautioned:

> … you would need to be pretty confident that it is seriously overvalued or that the market is behaving in some quite irrational way before you would launch on large-scale intervention, and we have not done that in this episode.[41]

2.27 The Governor told the committee that from his experience the markets 'have done a better job setting that price [of the exchange rate] than we would have done if we had been trying to set it'.[42]

Reserve Bank Reserve Fund (RBRF)

2.28 The annual report observes that the RBRF was 'substantially depleted' between 2009 and 2011. [43] In that context the Governor was asked whether it was 'prudent' of the Treasurer to pay a dividend of $500 million to the Australian Government.[44] In 2011 the Governor stated:

39 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 8.

40 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 3.

41 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 8.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 9.

43 RBA, *Reserve Bank of Australia: Annual Report*, 2012, p. 63.

44 RBA, *Reserve Bank of Australia: Annual Report*, 2012, p. 63.

> Nonetheless, the prudent course will be to apply future earnings to rebuilding the RBRF before the resumption of dividend payments. The Australian Government's budget projections have been made on this assumption.[45]

2.29 The Governor explained that his priorities — as the Governor of the RBA — may differ from those of the Treasurer:

> … purely from the point of view of the RBA, which is my responsibility, I believe the prudent and best course is to rebuild that reserve as quickly as we can. But I am not subject to the other pressures that the government have. They have got a range of prudent considerations that they have to make which extend far more broadly than the Reserve Bank. That is the balance that they have to strike and it is the Treasurer's prerogative to do that.[46]

2.30 The Governor would not be drawn further on the argument:

> We are going to get into a debate about the word 'prudent' and what is prudent from a narrow point of view might not be totally prudent from a broader point of view.[47]

2.31 The Governor explained that generally it was his preference to retain the entire reserve and rebuild it. The Governor explained that generally the Bank looks to have the reserve at 10 per cent of assets at risk. At present the Governor indicated that they are a 'few billion' short of their target, and it was expected that it would take some years to rebuild.[48]

2.32 The committee questioned the Governor about the current level of the RBRF and the Treasurer's decision to withdraw a dividend of $500 million from the RBRF's $1,096 million earnings for distribution.

2.33 The Governor was asked whether the board had been 'consulted' by the Treasurer before the money was withdrawn from the fund. The Governor explained that the Bank generally provided advice about the fund's yearly earnings and what the Board wished to do with them. Consequently he had discussed with the Treasurer, his preference to retain all the funds but this did not eventuate:

> My preference was—and this was expressed—that I would like to retain the whole 1,096, I think it was, to build up the Reserve Bank Reserve Fund. But he did not agree with that, and then we had to

45 RBA, *Reserve Bank of Australia Annual Report*, 2011, p. 1.

46 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 12.

47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 12.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 12.

> have a further conversation to come to an agreement as to what was going to happen.[49]

2.34 The Governor explained that it was the Treasurer's prerogative to access the funds, as the annual report details:

> Under the Reserve Bank Act, sums may be credited to the RBRF from earning available for distribution as determined by the Treasurer, after consulting the Board.[50]

Real-time payments

2.35 In his opening statement the Governor discussed the Payments System Board's work on real-time payments. At present only large transactions between financial institutions are settled in real-time. Real-time payments for all consumers will mean that transferred funds are immediately available to the recipient. The Governor told the committee that:

> In June last year, the Payments System Board released the conclusions from its strategic review of innovation… One of the gaps identified was the inability of businesses and consumers to make payments through the banking system effectively in real time, including in cases where the payer and the receiver bank were different institutions. The Payments System Board believes that Australia should over the medium term develop that capability, and have proposed a target for the industry to achieve that goal by the end of 2016. [51]

2.36 At its 15 February meeting, the Payments System Board was briefed on a proposal to establish an industry based project to deliver a real-time payment solution for Australia. The proposal was prepared by the Real Time Payments Committee, an industry committee with representation from a range of institutions.[52]

2.37 The committee was interested in the tangible benefits to businesses and consumers from real-time transfers. The Governor described for the committee how the system would work in practice:

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49 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 13.

50 RBA, *Reserve Bank of Australia: Annual Report*, 2012, p. 63.

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 3.

52 RBA, Media Release: Industry Proposal for a Fast Payments Solution, <http://www.rba.gov.au/media-releases/2013/mr-13-03.html>.

> You and I go for dinner, you put the bill on your card and I will reimburse you, and you get the money now while we are sitting there, or within five minutes, rather than the day after tomorrow. Why can't we do that? Technically, that ought to be feasible. It is. It takes a fair bit of investment and it takes cooperation between players who are otherwise competing to build it. That is the benefit we are looking for.[53]

2.38 Secondly, the system will benefit consumers as they will have their money to earn interest on immediately, rather than the banks.[54]

The net interest margins of the major banks

2.39 The Governor was questioned about the spread between the cash rate and a standard variable loan.[55] The Governor explained that in net terms the costs to banks have increased in the last five years.[56] While, the net interest margins 'have been in a reasonably narrow range for quite some years now':

> The spread that matters is not really doing much. My point is that the spread that drives the profits—which essentially is the thing they call 'net interest margin'—it is going up and down a little bit month to month or quarter to quarter but basically it is within a range that has not really shifted in the last several years. Yes, they make record profits. They are handsomely profitable institutions, but they are very big institutions and you would expect them to make large absolute profits.[57]

2.40 The Governor also noted that the actual rate borrowers were paying was 'appropriate' for the economic circumstances.[58]

2.41 The committee then moved to discuss with the Governor the issue of refinancing loans. The Governor indicated that presently there are between four and five million loans in Australia.[59] Of these loans, 15,000

53 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 10.
54 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 10.
55 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.
56 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.
57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 16.
58 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 15.
59 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 16.

are refinanced every month, either by a new bank or at the same institution. As the Deputy Governor, Dr Lowe, pointed out

> … you do not actually have to switch banks to get a better deal. In the current environment, if you go to your bank and say, 'I'm going to switch unless you lower my interest rate,' it often happens.[60]

Conclusion

2.42 While the committee was heartened by the positive economic news presented by the Governor, it remains acutely aware of the potential problems that could eventuate in the global economy. To ensure that Australia's economic interests are served, the Australian Government and the RBA must continue to make sound and decisive decisions which improve the economy's resilience and promote growth.

Julie Owens MP
Chair
13 March 2013

60 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 22 February 2013, p. 17.

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Friday, 22 February 2013 – Canberra

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Dr Philip Lowe, Deputy Governor
Dr Christopher Kent, Assistant Governor (Economic)

Private briefing

Wednesday, 13 February 2013 – Canberra

Professor Warwick McKibbin, Chair in Public Policy, Centre for Applied Macroeconomic Analysis, Crawford School of Public Policy, Australian National University

B

Appendix B — *Fourth 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