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Monetary policy and other issues

Overview

2.1 The Australian economy has performed exceptionally well and suffered less from the impact of the global financial crisis than most other advanced economies. The February 2010 hearing was set against optimistic forecasts for growth and stability. Australia was one of the few advanced economies not to fall into recession.

2.2 Through 2009 Gross Domestic Product (GDP) grew by about 2 per cent and in 2010 GDP is expected to reach about 3 per cent. Unemployment is trending down and hours worked is increasing. The strength of the upturn in the Asia-Pacific is quite strong which is helping Australia to achieve higher growth prospects. In the large industrial countries, however, growth has been more tentative.

2.3 As a result of Australia's positive growth prospects, the Reserve Bank of Australia (RBA) began lifting the policy cash rate from its emergency low of 3.00 percent. The cash rate was raised three times in succession between October and December 2009. In March 2010 the cash rate was lifted another 25 basis points taking the new cash rate to 4.00 per cent.

2.4 During the hearing, the committee examined the RBA on the key forecasts for the economy focusing on inflation and growth and their influence over the policy cash rate during the next 12 months. The committee examined some of the possible constraints to growth and possible impacts which could lead to inflationary pressures. In addition, the committee examined issues affecting bank funding.

Forecasts for the economy

2.5 The RBA remains optimistic about Australia's economic outlook. Its central forecast is for the economy to grow by just over 3 per cent during 2010 and reach trend levels of 3½ per cent through 2011 and 2012. The RBA noted that 'conditions in the domestic economy have been somewhat stronger than was expected in mid 2009.'[1] The RBA stated that 'as the stimulus fades, private demand will become a more important driver of growth, reflecting solid household spending and strong business investment.'[2] The RBA's key output and inflation forecasts are reproduced in Table 2.1.

2.6 The RBA's forecast for year ended underlying inflation is expected to be around or below 3 per cent in the March quarter and to fall to around or slightly below 2½ per cent in late 2010 and early 2011.[3] The RBA noted that 'the forecasts are based on the technical assumption of a rise in the cash rate over the forecast period, with the assumed path broadly consistent with market expectations'.[4]

2.7 In relation to risks to the forecasts, the RBA noted that they 'appear to be fairly balanced.' The RBA stated:

> Perhaps the most likely scenario in which growth and inflation are both significantly higher than expected is one in which confidence continues to build on the back of a further pick up in commodity prices and there is a larger increase in investment in the resources sector than currently expected. In this scenario, non-residential construction might also pick up more quickly than is currently expected as credit constraints ease. If this were to occur, capacity constraints, particularly in the construction sector, would be likely to emerge and wage growth would be likely to accelerate more quickly than currently expected. The result would be higher inflation.[5]

2.8 The RBA noted that the outlook for the world economy has improved since the November 2009 quarterly statement. Global output is now expected to grow by about 4 per cent in year-average terms in both 2010 and 2011. Australia's terms of trade 'are forecast to increase over the

1 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, p. 58.
2 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, p. 58.
3 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, p. 59.
4 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, p. 58.
5 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, pp. 59-60.

coming year, reflecting higher prices for Australia's commodity exports and subdued growth in the prices of manufactured imports.'[6]

2.9 The speed of global growth is variable. The Asia-Pacific has seen a significant pick-up in production and trade. In relation to the large industrialised economies, the Governor noted that 'growth in these cases is therefore expected to remain modest and, as a result, these economies…are likely to be characterised by quite a lot of spare capacity and ongoing high unemployment.'[7] In relation to the disparity in growth, the Governor stated:

> So the shift in the centre of economic gravity to the Asian region is continuing, and if anything it has been highlighted by the different performances in the crisis and the initial recovery. The differences in speed of recovery between the emerging world and the advanced world, and the likely persistent differences in growth trajectories into the future, will I think increase the pressure on exchange rate arrangements in the Asian region.[8]

Table 2.1 RBA Output and Inflation Forecasts (a)

	June 2009	*Dec 2009*	*June 2010*	*Dec 2010*	*June 2011*	*Dec 2011*	*June 2012*
GDP	0.6	2	2½	3¼	3½	3½	3½
Non-farm GDP	0.6	2¼	2½	3¼	3½	3½	3½
CPI	1½	2.1	3	2½	2½	2¾	2¾
Underlying inflation	3¾	3¼	2½	2½	2½	2¾	2¾

(a) Actual GDP data to June 2009 and actual inflation data to Dec 2009. For the forecast period, technical assumptions include A$ at US$0.88, TWI at 69, and WTI crude oil price at US$85 per barrel and Tapis crude oil price at US$88 per barrel. Sources: ABS; RBA

Source *Reserve Bank of Australia, Statement on Monetary Policy, 5 February 2010, p. 58.*

Inflation targeting and monetary policy

2.10 The RBA's inflation objective, agreed with the Government, is to keep consumer price inflation between 2 and 3 per cent, on average, over the cycle. As indicated in the forecasts, consumer price inflation and, more importantly, underlying inflation are forecast to both fall to around 2½ per cent by December 2010. The Governor advised that as the downturn was

6 Reserve Bank of Australia, *Statement on Monetary Policy*, 5 February 2010, p. 57.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 2.

less severe than previous downturns there was less spare capacity should growth pick up significantly. The Governor commented that as a result there is less scope for robust demand growth without inflation starting to rise again down the track. The Governor cautioned that 'monetary policy must therefore be careful not to overstay a very expansionary setting.'[9] The Governor stated:

> But the thing for us to be watching is how quick the pick-up in demand is, relative to available capacity. As I said at the beginning, we have some spare capacity generally in the economy but a fair bit less than you would normally get if you had a serious recession. It is good that we do not have a lot of spare capacity. You do not want to have a lot. But, equally, you want to be watching the pace of demand for growth when you do not have much because you are wary of the potential for inflation. That is why we are in this period of moving off the emergency rates.[10]

2.11 The Governor confirmed that if conditions evolved as expected then 'further adjustments to monetary policy will probably be needed over time to ensure that inflation remains consistent with the target over the medium term.'[11] In relation to how close the policy cash rate was from 'normal', the Governor stated:

> The way I would characterise it is that I do not think we are in emergency anymore; I think we have done enough to lift off that. I would say that if you looked at the borrowing rates being actually paid on average by both business and housing borrowers, they are still below what I would call an average for the past decade or so; they are probably between 50 and 100 points below that average or something like that. So we are a fair bit closer to normal now than we were when we last met with you, given what we have done and what the banks added on top of that. When we eventually get to normal, there is a bit more work to do there but I think that is the order of magnitude we are talking about.[12]

2.12 A feature of the recent downturn was a less severe increase in the unemployment rate. However, there was a reduction in hours worked. A similar trend occurred during the 2001 downturn. It was pointed out during the hearing that the ability to adjust working hours and therefore reduce the level of unemployment was a feature of a highly flexible labour

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 3.
10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 19.
11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 4.
12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 5.

market. In relation to the point that labour flexibility had been a contributing factor to reducing the level of unemployment, the Governor stated:

> It has been, but of course the new arrangements are just coming in. So the test is whether the flexibility is retained. I am not saying it will not be. I cannot judge, but the question being asked is whether that is a potential risk. As I say, it is important to retain flexibility and it is very important that all the parties involved do that.[13]

2.13 As demand picks up, hours worked are expected to increase with the unemployment rate falling less quickly. The RBA stated:

> Going forward in our forecast we do not have the unemployment rate going down that quickly, because as the economy strengthens we will see average hours lengthen out and reverse that earlier decline. I think that is going to be the first thing we will see. Once that process plays its way through then we would expect the unemployment rate to come down more. But there is a reasonable amount of spare capacity there because people are working fewer hours.[14]

2.14 The Governor was examined about the potential inflationary impact of wage pressures without commensurate productivity gains. The Governor accepted that there may be some growing wage pressures but this had been taken account of in arriving at the inflationary forecasts. The Governor stated:

> I think there probably is going to be some intention to catch up. We are factoring some of that into our forward-looking assessment. That is why we think inflation is not going to keep falling. Nine months ago we would have said inflation was going to keep falling to maybe 1½ per cent. Now the low point is 2½ per cent and we think that probably, if economy works out in the way we expect it to, it will start to drift higher from there. That is why we are talking about the fact that we will probably need to tighten further, if things work out as we expect them to. Expectations of inflation I think are okay at the moment.[15]

2.15 During the debate about inflation targeting, the Governor was asked about the merits of an International Monetary Fund (IMF) staff position paper that policy makers should consider adopting a higher inflation

13 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 12.

14 Dr Philip Lowe, Assistant Governor, RBA, *Transcript*, 19 February 2010, p. 25.

15 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 19.

target of perhaps 4 percent.[16] The reasoning behind this proposal relates to the point that many countries had very low policy cash rates and when the financial crisis struck there was little room to move. The IMF paper asked the question 'should policy makers therefore aim for a higher target inflation rate in normal times, in order to increase the room for monetary policy to react to such shocks?'[17] It should be noted that in Australia at the time Lehman Brothers collapsed, the policy cash rate was 7.25 and in Australia there is generally very good 'transmission' between movements in the policy cash rate and market rates. The Governor disagreed with the proposal to increase the target rate and stated:

> On inflation targets: I do not agree at all with what the IMF paper said there. The basis for the argument that maybe you need a higher average inflation rate is so you can then have higher average interest rates, and that means you could cut them more in an emergency, and the reason they think that is a good idea is that these countries hit the lower bound, of zero. We have an inflation target centred on 2½, and we had 300 points left when we got to the bottom that we could have used but did not need to. So it seems to me that this problem, in our case, has not—has not anything like—arisen. I think it might well be argued that some of these countries should have had higher average interest rates than they did. But they did not actually need a higher inflation target to do that. That is a line of argument that many people ran—that rates were just too low.[18]

Monetary policy and asset price bubbles

2.16 The role of monetary policy in addressing asset price bubbles was examined in the previous two hearings with the RBA. This issue is part of wider contemporary debate and was discussed as part of the RBA's 50th Anniversary Symposium.[19] In relation to risks associated with asset price bubbles, Cagliarini, Kent and Stevens stated that 'even with the

16 International Monetary Fund, Staff Position Note, O. Blanchard, G. Dell'Ariccia, P. Mauro, *Rethinking Macroeconomic Policy*, 12 February 2010, p. 11.

17 IMF, Staff Position Note, *Rethinking Macroeconomic Policy*, 12 February 2010, p. 11.

18 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 23.

19 Reserve Bank of Australia, 50th Anniversary Symposium, A. Cagliarini, C. Kent & G. Stevens, *Fifty Years of Monetary Policy: What Have We Learned?* 9 February 2010, pp. 29-32; 50th Anniversary Symposium, J. Caruana, *Financial Stability: 10 Questions and About Seven Answers*, 9 February 2010, pp. 7-8.

development of other tools, it is unlikely to be credible for central banks not to move, in the next decade, at least somewhat in the 'responsive' direction.'[20] In the paper entitled *Financial Stability: 10 Questions and about Seven Answers*, Caruana stated that 'the Reserve Bank's interest rate policy in 2003 rightly erred on the side of tightness in the face of strong growth in house prices and credit.'[21]

2.17 The RBA in its response at the hearing cautioned that there is a difference between targeting asset price, and responding to financial developments cautiously. The RBA stated:

> I think it is important that people do not think of this as the central bank targeting asset prices or pricking asset price bubbles, because I do not think anyone thinks that is sensible. The issue is really: if you are seeing imbalances develop in the financial system, what should monetary policy and regulatory policy do? As the governor said, I think the weight of opinion is shifting towards the view that both regulatory and monetary policy need to do something.
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> These financial imbalances arise if credit is growing very quickly, if asset prices are growing very quickly and you have got a lot of innovation and competition and new things happening in the financial system. That particular cocktail leads to risk building up, and I think there is a strong case for the central banks and the regulators to take note of that and not just stand by and allow the imbalances to build up and then ultimately correct. But it is not about targeting asset prices; it is not about pricking bubbles. It is about responding to financial developments in a sensible way.[22]

2.18 It was noted during the hearing that house prices in the year to the 2009 December quarter had increased by about 13 per cent, and in the context of the debate about asset price bubbles was this a concern. The Governor noted that it would be a concern if it continued but noted that there were positive signs in relation to housing credit and improved lending practices. The Governor stated:

> Firstly, the rate of growth of housing credit behind that is about eight per cent. That is quite healthy; I would not regard that as grossly excessive—it used to be 18. One of the real worry points

20 Reserve Bank of Australia, 50th Anniversary Symposium, *Fifty Years of Monetary Policy: What Have We Learned?* 9 February 2010, p. 32.

21 50th Anniversary Symposium, J. Caruana, *Financial Stability: 10 Questions and About Seven Answers*, 9 February 2010, p. 8.

22 Dr Philip Lowe, Assistant Governor, RBA, *Transcript*, 19 February 2010, p. 10.

> you are looking for is rapidly rising asset values, very strong growth in credit and declining lending standards. What we have is pretty strong growth in house prices over the past year—I will come back to a nuance there in a moment—but credit growth is not too bad; it is moderate. Lending standards for households are actually increasing, not falling. Banks are tending to reduce loan-to-value ratios—you have got to have a bigger deposit and so on, and I do not think you can get a no deposit loan now et cetera. I welcome that; I think that is a very good thing. We may well see more of that if house prices continue to escalate because the banks own risk management will tell them, 'Be careful here, and maybe be a bit tougher on the standards.' That is what they should do.[23]

Fiscal stimulus

2.19 As the economy is returning to higher levels of growth the RBA has increased the policy cash rate from their 'emergency levels'. During the hearing, the Governor was asked about the impact of fiscal stimulus on the economy.

2.20 In particular, it was noted that in an RBA 50th Anniversary Symposium Paper, the authors stated that 'there may well be attractions for fiscal authorities in committing to a path of relatively rapid fiscal consolidation, thereby allowing monetary policy to be more accommodative than otherwise.'[24] There was some confusion in the media that this statement was made in relation to the current Australian context. The Governor rejected this and advised that the paper stated that it 'is not intended to provide any particular message about current issues for monetary policy in Australia.'[25] The Governor freely acknowledged that the principle behind the statement was correct and that is why it was stated in the paper.

2.21 The Governor was asked about how monetary and fiscal stimulus had worked together to address the downturn and the timing involved in withdrawing the stimulatory measures. The Governor stated:

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23 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 16.

24 Reserve Bank of Australia, 50th Anniversary Symposium, *Fifty Years of Monetary Policy: What Have We Learned?* 9 February 2010, p. 35.

25 Reserve Bank of Australia, 50th Anniversary Symposium, *Fifty Years of Monetary Policy: What Have We Learned?* 9 February 2010, p. 2.

> I think the general story when we met last time was that it was understood that, once the job has been done, both arms of policy have to move in the direction of withdrawing stimulus. We have begun our withdrawal. I think it is still our assessment that the peak effect of the budgetary measures on the growth rate of demand was in the middle of last year. Its peak effect on the level of demand is about now. If things run to time—and it is important that they do—it should tail off over the year ahead. So I do not think I have anything new to say about that. For both arms of policy I suppose we have to keep re-evaluating the outlook for the economy and amending our trajectory—in our case, anyway, it is easy to amend. It is not as easy to do with fiscal policy but, if necessary, we can amend the pace at which we withdraw our stimulus as views about the outlook shift to views that are somewhat more optimistic now than they were in August.[26]

Sovereign debt

2.22 Prior to the hearing, public reporting had indicated that Australia might be at risk of defaulting on its sovereign debt. The committee is of the view that a claim like this is irresponsible and has the potential to undermine the economy and therefore it could not be ignored. The Governor was asked to comment and he provided reassurance that the prospect of Australia defaulting on its sovereign debt was highly unlikely. The Governor stated:

> There are few things less likely than Australia defaulting on its sovereign debt. There has never been a default by this country. I do not think there has been a default by any of the states, with one exception for one day, which the Commonwealth stepped in and fixed in 1931. There has never been an event of sovereign default by Australia as far as I know, and I very much doubt there ever will be.[27]

26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 8.
27 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 7.

Bank funding

2.23 The committee's examination of bank funding centred around the Deputy Governor's speech on bank funding on 16 December 2009.[28] The Deputy Governor noted that banks have a diverse funding base with the key sources including:

- deposits which account for 43 per cent of funding split fairly evenly between households and businesses;
- domestic capital markets provide a further 19 per cent of funding;
- foreign capital markets provide 28 per cent; and
- securitisation and equity account for 3 per cent and 7 per cent respectively.

2.24 The Deputy Governor noted that while individual banks have a large amount of discretion in the way they fund themselves, the banking sector has less flexibility. The Deputy Governor stated that 'for the banking system as a whole, the share of deposits in total funding can increase only to the extent that investors reduce their holdings of securities and place the proceeds on deposit with banks.'[29] The Deputy Governor noted that 'the trend in most economies is for savings over time to move away from simple instruments such as bank deposits towards debt securities and equities.' The Deputy Governor stated:

> The so-called 'deposit war' among banks is producing very attractive interests rates for depositors but little net benefit for the banking system as a whole in terms of increasing deposit funding.[30]

2.25 This competition by banks for deposits is increasing the cost of funds. Previously, banks on average paid about 125 basis points less than the cash rate on deposits. Currently, the banks are paying 'interest rates that are on average in line with the cash rate.'[31] In noting that bank funding costs have increased, the Deputy Governor noted that 'these changes in banks' costs of funds relative to the cash rate have meant that the

28 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Some Comments on Bank Funding*, Remarks to the 22nd Australasian Finance & Banking Conference, 16 December 2009.

29 Mr Ric Battellino, Deputy Governor, *Some Comments on Bank Funding*, p. 4.

30 Mr Ric Battellino, Deputy Governor, *Some Comments on Bank Funding*, p. 4.

31 Mr Ric Battellino, Deputy Governor, *Some Comments on Bank Funding*, p. 5.

relationship between bank lending rates and the cash rate has also become looser.'[32] The Deputy Governor stated:

> The margin between the cash rate and banks' lending rates receives considerable public attention. This is understandable because changes in it are very visible. This margin, however, can change for many reasons, so it is difficult to interpret. A widening in it might be due to banks making unjustified increases in their lending rates, or it might reflect market developments that have pushed up banks' cost of funds relative to the cash rate.
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> Some have argued that variability in this margin means that monetary policy is less effective. This, however, misses the very important point that the Reserve Bank takes account of the changing relativities between the cash rate and other interest rates when setting the cash rate. Other things equal, if interest rates in the economy are rising relative to the cash rate, there is less need for the cash rate to rise.[33]

2.26 The discussion about bank funding also linked to possible future rules on capital and liquidity requirements of banks. There is a growing push within the G20 to make banks safer. The Basel Committee on Banking Supervision has a key role in developing banking supervision standards. The Governor noted that the outcome of future proposals 'is likely to be tougher capital requirements, particularly on trading book assets—the securities the banks trade for their own purposes; and tougher standards on liquidity.'[34]

2.27 The Governor noted that the purpose of the increased standards is 'the 30 or 40 globally active, very big institutions which took more risk than they should have given the capital they had, got into serious trouble and therefore placed immense strains on their home economies, on the global financial system and in some cases required a considerable amount of taxpayers' money in their own country to rectify the situation.'[35]

2.28 During the hearing, the concern was raised that Australian banks which operated more prudently compared to some overseas counterparts could be adversely affected by the increased capital and liquidity requirements. In response to this concern, the Governor commented that 'we want to be sure that in addressing the egregious problems that these 30 or 40 large

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32 Mr Ric Battellino, Deputy Governor, *Some Comments on Bank Funding*, p. 6.

33 Mr Ric Battellino, Deputy Governor, *Some Comments on Bank Funding*, p. 7.

34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 13.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 13.

institutions created we do not unnecessarily and inadvertently impair the thousands of other banks in the world who have been okay.'[36] The view of the committee was that the Basel discussions were more about developing a 'North Atlantic' solution to a problem that does not exist in Australia. The Governor in response to this stated:

> We have made our points known, and APRA puts these points, about the liquidity rules—in particular through their membership of the Basel committee, as do we. What we need here is to just make sure that there is a certain amount of national discretion, which there always is in these capital rules. That is why Basel II took 20 years to negotiate. So we need to do that, which is why I say that it is imperative that these proposed standards be very carefully quantitatively assessed; that should be thoroughly done, with time to negotiate sensible flexibility for countries like us.
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> It is a very good phrase: the whole crisis actually was very much a North Atlantic crisis. It was really only a global crisis for six or eight weeks, I think. The rest of it is mainly a North Atlantic story.[37]

Conclusions

2.29 It is now becoming more evident that the Australian economy, supported by demand from Asia-Pacific countries, is on the path to trend growth of about 3½ per cent. Through effective monetary and fiscal policy the Australian economy was able to avoid the worst of the global financial crisis and position itself for a return to robust growth. This still presents challenges, however, as the economy may have less capacity coming out of this downturn compared to previous downturns. The RBA's management of monetary policy over the next 12 to 18 months is critical to ensuring that inflation remains in the target zone.

2.30 The committee will examine the RBA over its management of monetary policy and the state of the economy at the next public hearing scheduled for 27 August 2010 in Canberra.

Craig Thomson MP
Chair
11 March 2010

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36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 13.

37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 19 February 2010, p. 21.