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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]

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:

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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.