The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2009 (First Report)

House of Representatives Standing Committee on Economics

March 2010
Canberra

ISBN 978-0-642-79295-2 (Printed version)

ISBN 978-0-642-79296-9 (HTML version)

Foreword

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. It is notable that Australia was one of the few advanced economies not to fall into recession.

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.

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.

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.

The committee also dealt with the public claim that Australia might be at risk of defaulting on its sovereign debt. The committee was of the view that a claim like this is irresponsible and has the potential to undermine the economy. The Governor advised that '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.'

In conclusion, I would like to, on behalf of the committee, note that this is the 50th Anniversary of the Reserve Bank of Australia. On 14 January 1960 the RBA commenced operations under its first Governor, Dr H.C. 'Nugget' Coombs. The committee notes the contribution the RBA has made to the stability of the Australian economy and looks forward to its continuing contribution in the years ahead.

On behalf of the committee, I would like to thank the Governor of the Reserve Bank, Mr Glenn Stevens and other representatives of the RBA for appearing at the hearing on 19 February 2010. The next public hearing will be held on 27 August 2010 in Canberra.

Craig Thomson MP
Chair

Contents

APPENDICES

Membership of the Committee

Chair	Mr Craig Thomson MP	
Deputy Chair	The Hon Kevin Andrews MP (to 3/2/10) Mr Jamie Briggs MP (from 11/2/2010)	
Members	Mr David Bradbury MP	The Hon Bruce Billson MP (from 3/2/2010)
	The Hon Joel Fitzgibbon MP	Mr Luke Hartsuyker MP (from 3/2/2010)
	Ms Sharryn Jackson MP	The Hon Sussan Ley MP (from 3/2/2010)
	Ms Julie Owens MP	Mr Scott Morrison MP (to 3/2/10)
	Mr Jim Turnour MP	

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Ms Sharon Bryant
Administrative Officer	Ms Renee Burton

Terms of reference

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.

List of abbreviations

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

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 *Fourth Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Wayne Swan, MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix B, states:

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

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

responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual reports of the RBA.

Scope and conduct of the review

1.4 The fifth public hearing of the committee with the RBA during the 42nd Parliament was held in Canberra on 19 February 2010.

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

1.6 Before the hearing, the committee received a private briefing from Mr Bill Evans, Chief Economist, Westpac. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Evans cooperation and assistance.

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

1.8 The hearing was well attended by members of the public and staff and students from East Hills Girl's Technology High School, Daramalan College, Canberra Girl's Grammar School, The Canberra College and Canberra Grammar School. The committee appreciates the assistance of Annemieke Jongsma from the Parliamentary Education Office for organising the attendance of school students at the hearing.

1.9 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and have assisted in providing a public face to parliamentary committees and the RBA. The committee welcomes the Governor's frank and open comments at the hearings. In addition, the hearings are an important means whereby financial markets can be better informed on the current thinking of the RBA.

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

---

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

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

Next public hearing with the Reserve Bank of Australia

1.11 The committee will conduct the next public hearing with the RBA on 27 August 2010 in Canberra. More details will be circulated in the weeks leading up to the hearing.

2

Monetary policy and other issues

Overview

2.1 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.
>
> 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:

---

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.
>
> 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

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.
>
> 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

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.

A

Appendix A — Hearing, briefing, and witnesses

Public hearing

Friday, 19 February 2010 – Canberra

Reserve Bank of Australia

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

Private briefing

Thursday, 11 February 2010 – Canberra

Mr Bill Evans, Chief Economist, Westpac

B

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

The Treasurer and the Governor of the Reserve Bank

6 December 2007

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

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

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

This statement should continue to foster a better understanding, both in Australia and overseas, of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Reserve Bank.

Relationship between the Reserve Bank and the Government

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

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

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

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

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

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

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

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

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act, which requires the Reserve Bank Board to conduct monetary policy in a way that, in the Reserve Bank Board's opinion, will best contribute to:

a) the stability of the currency of Australia;

b) the maintenance of full employment in Australia; and

c) the economic prosperity and welfare of the people of Australia.

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

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

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

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

Transparency and Accountability

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

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

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

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

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

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

C

Appendix C — Glossary of terms

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

labour force. The employed plus the unemployed.

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

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

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

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

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

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

natural increase. Excess of live births over deaths.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Source: Parliamentary Library and Reserve Bank of Australia