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

House of Representatives Standing Committee on Economics

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Chair’s foreword

Over the last several years the Australian economy has, by any reasonable standard, been an outstanding performer. While many leading economies across the world continue to suffer from the effects of the global financial crisis, Australia has experienced steady growth throughout its economy as a whole, with significant gains in key sectors, such as the export-oriented mining industry. The hearing confirmed the wisdom of the economic reforms that Australia has undertaken over the last generation, reforms that have provided us with a legacy of hard-won economic resilience.

The forecasts for Australian growth and stability provided by the RBA in late 2010 were positive. At the time of the hearing, Australian consumer price inflation was about 2½ per cent in underlying terms and about 2¾ per cent in headline terms and the bank forecast was for the economy to grow by 3½ per cent on an annual basis from the December quarter 2010, rising to a possible high of 4 per cent by the end of 2011.

This forecast preceded the cataclysmic flooding that has swept across the eastern states, especially Queensland and shall most likely be revised subject to a systematic reconsideration of the latest developments. Yet, regardless of what revised form the updated forecast ultimately takes, the November hearing offered us a valuable insight into the Australian national economy before the floods.

Largely due to our favourable terms of trade (made possible by the urbanisation of China and India, with its resultant pressure on the price for minerals and fuel) Australia was rapidly closing the gap between actual and potential output. The principal drivers for economic growth were increases in private investment, robust income growth and a strong labour market. In the view of the RBA, the great challenge ahead was to raise productivity and expand the supply side of the economy. While inflation was lower than expected, the bank board expected that the prospect of further increases in the cash rate was sufficiently serious to justify their decision to raise interest rates in early November.

In conclusion, I would like to thank, on behalf of the committee, the Governor of the Reserve Bank, Mr Glenn Stevens, and the other representatives of the RBA for appearing at the hearing on 26 November 2010.

Craig Thomson MP
Chair

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Membership of the Committee

Chair	Mr Craig Thomson MP
Deputy Chair	Mr Steven Ciobo MP
Members	Mr Scott Buchholz MP
	Mr Stephen Jones MP
	Dr Andrew Leigh MP
	Ms Kelly O'Dwyer MP
	Ms Julie Owens MP

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Terms of reference

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

List of abbreviations

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

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Introduction

Background

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

1.2 The appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Wayne Swan, MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the bank's 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

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

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

Scope and conduct of the review

1.4 The first public hearing of the committee with the RBA during the 43rd Parliament was held in Canberra on 26 November 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 Brian Redican, Senior Economist, Macquarie Bank. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Redican's cooperation and assistance.

1.7 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.

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

Next public hearing with the Reserve Bank of Australia

1.9 The committee will conduct the next public hearing with the RBA on 26 August 2011 in Canberra. More details will be circulated in the weeks leading up to the hearing.

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

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

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Monetary policy and other issues

Overview

2.1 The outlook for the Australian economy is positive. The economy continues to perform well by comparison with other advanced countries. The near to medium term prospects for elements of the global economy remain uncertain, but Australia enjoys such strong growth that the Board of the Reserve Bank of Australia decided at its November 2010 meeting to lift the cash rate by 25 basis points. This left the overall setting of monetary policy a little tighter than average, but the Board judged this to be appropriate for the period ahead, in which growth in GDP is expected at a little more than 3 per cent.

2.2 For its part, the RBA remains committed to the same framework for monetary policy that it has followed for the past two decades, keeping the growth of demand sustainable, so as to achieve an average inflation rate of between 2 and 3 per cent.

2.3 At the time of the hearing, Australian consumer price inflation was about 2½ per cent in underlying terms and about 2¾ per cent in headline terms. The RBA expects that inflation will remain consistent with the target, though further ahead the medium-term risks on inflation probably lie in the direction of it being too high, rather than too low.

2.4 As a result of Australia's strong economic growth, the remaining gap between actual and potential output is small. The November 2010 hearing of the committee was set against optimistic forecasts for Australia's future growth and stability, though an important element of the wider context at the time was public controversy over the decision of the major banks to raise their lending rates above the RBA cash rate. The banks received significant public criticism for their unwillingness to absorb the increase in the cash rate out of their profits. There were also claims that there was insufficient competition in the domestic banking sector.

2.5 The most significant driver of Australia's economic growth has been the terms of trade. These now exceed the six-decade highs of several years ago. According to the Governor of the Reserve Bank, Mr Glenn Stevens, the terms of trade are near an all-time high. These are being driven up by the demand for Australian raw materials, which has in turn generated a major surge in business investment in the minerals sector.

2.6 The demand for Australian resources comes from Asia, which has experienced steady growth. Much of this demand comes directly from China and, to a lesser extent, India. Rapid urbanisation has ensured strong ongoing demand for steel. While the RBA forecasts assume a gradual decline in both iron ore and coal prices over the medium term due to an increase in supply, prices are nonetheless expected to remain high. GDP in both China and India is expected to continue to grow at a rate of 10 per cent per annum. The RBA is satisfied that Asian growth has returned to a sustainable pace, now that a number of countries (including China) have gradually withdrawn the monetary and fiscal stimulus that they had been applying.

2.7 By contrast, countries at the centre of the financial events of 2007 and 2008 have so far experienced subdued recoveries. The G7 countries are expected to grow at a rate of about 2½ per cent, following a contraction of 3½ per cent in 2009. This will leave a considerable margin of spare capacity, particularly of unemployed labour. In addition, global financial markets have continued to improve, but were increasingly focussed on the rise in sovereign debt in a number of countries. The sustainability of this debt remains an issue for markets and policymakers.

2.8 Overall, global GDP growth is likely to be around 4¾ per cent, which is above the trend established in the previous decade. The RBA expects that within a year from now there should be some moderation in the rate of global growth.

Forecasts for the economy

2.9 The RBA remains optimistic about Australia's economic prospects: its central forecast is for economic grow of 3½ per cent from the December quarter 2010, reaching 4 per cent by the end of 2011. The RBA stated:

> The outlook is positive, supported by the expected strong growth in investment in the resources sector, the income boost flowing from the elevated level of commodity prices and ongoing solid population growth, albeit at a reduced pace relative to the high rate of around a year ago.[1]

2.10 The RBA reported a recent shift from public to private demand and noted that while stimulus spending contributed to GDP growth over 2009-10, there will be a subtraction from GDP growth in the period ahead as this effect gradually fades.[2]

2.11 The RBA's key output and inflation forecasts are available in numerical form in Table 2.1 and graphically in Figure 2.1. Key drivers for the strong rate of growth in GDP include: a pick-up in private demand, itself largely driven by business investment (especially investment in mining), robust growth in income and a strong labour market.[3]

Table 2.1 RBA Output and Inflation Forecasts (a)

	June 2010	*Dec 2010*	*June 2011*	*Dec 2011*	*June 2012*	*Dec 2012*	*June 2013*
GDP	3.3	3½	3½	3¾	3¾	4	4
Non-farm GDP	3.3	3¼	3¼	3¾	3¾	4	4
CPI	3.1	2¾	2¾	2¾	2¾	3	3
Underlying inflation	2¾	2½	2½	2¾	2¾	3	3

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

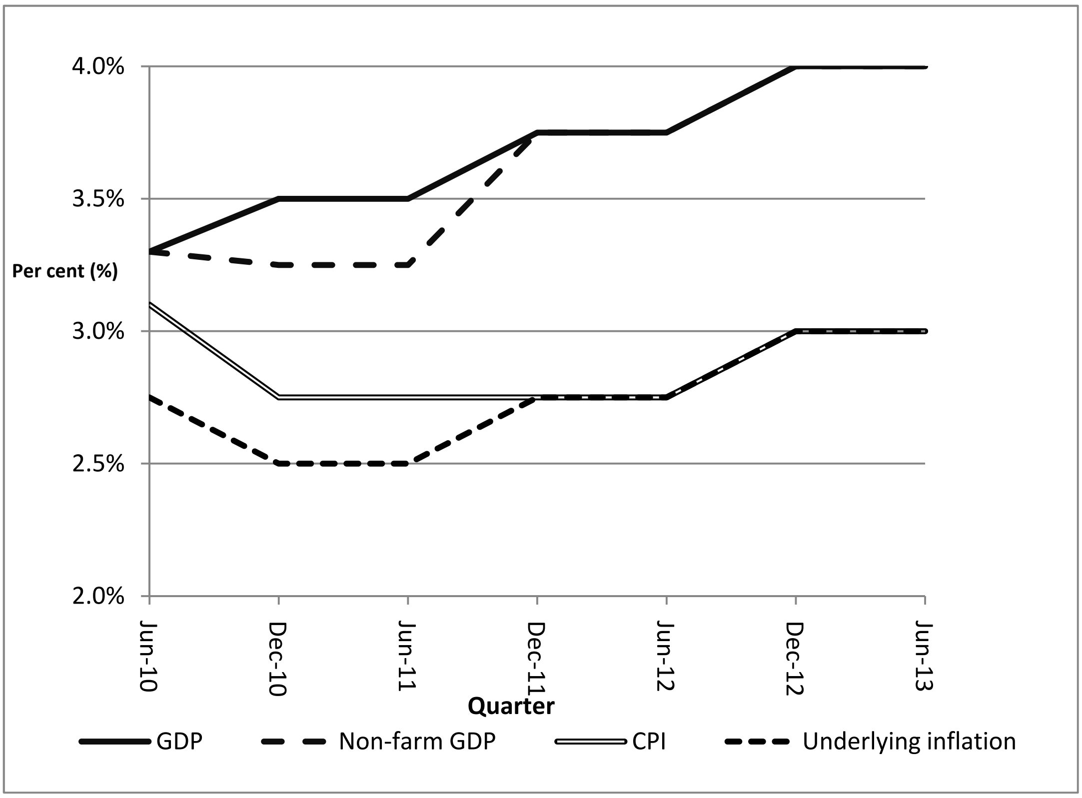
Source *Reserve Bank of Australia, Statement on Monetary Policy, 4 November 2010, p. 62.*

1 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

2 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

3 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, pp. 62-63.

Figure 2.1: RBA Output and Inflation Forecasts (per cent, by quarter)



Source *Reserve Bank of Australia, Statement on Monetary Policy, 4 November 2010, p. 62.*

2.12 The central forecasts rest on the technical assumption that the exchange rate remains at its current level and that changes in the cash rate are consistent with market expectations.[4]

Inflation targeting and monetary policy

2.13 The decision of the RBA Board to raise interest rates in November 2010 sparked public debate. The committee was interested in finding out what had prompted the Board's decision, given that inflation had appeared to be under greater control in November than it had in October. The Governor explained by stating that while the most recent inflation data was indeed 'a touch lower' than many had previously forecast, this was due to falling food prices, which he did not see continuing. Moreover,

4 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

there were indications from the producer price data that indicated 'a pick-up in pressure' on inflation.[5]

2.14 The Governor further developed his views on inflationary pressures by referring to the international situation. In his view, the US was not falling into another recession at this time, Europe continued to 'ebb and flow', while China was growing at a rate of 10 per cent for this year. To compound matters, Australia's terms of trade were having an increasing impact on the domestic economy. This impact was considerable, making it 'a once or twice in 100 years event'.[6]

2.15 The committee referred to the consensus amongst economists that the cash rate would probably reach around 5½ per cent in 2011 and asked if this view was consistent with the RBA's central case. The Governor noted that:

> What we will find is that the consensus can shift around a bit. It is only a few months ago that some market pricing suggested that the cash rate might actually fall before the end of this year, which, of course, it did not.[7]

2.16 Further to this statement, Dr Debelle added that market pricing currently has the cash rate rising to 5 per cent by the middle of next year, with a minor rise beyond that.[8]

2.17 The committee explored the RBA's 2 to 3 per cent inflation target and the level of variation within that range. The Governor advised that half the time inflation has been above or below that range, but insisted that it is not possible to fine-tune inflation so closely that it is never outside that band.[9] The RBA aims to keep activity within the ideal range, but to do so without crushing the real economy in the process. In his opinion, it would be a mistake to set a higher target for inflation, merely because of the difficulty in meeting the low one and 'that would get us higher interest rates in the long run'.[10]

2.18 During the hearing the committee noted the increase in utility prices. The Governor explained that the current rise in electricity prices, for example, was an effect of developing new capacity after a period of

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5 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, pp. 4-5.

6 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 6.

7 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 22.

8 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 22.

9 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 32.

10 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 33.

underinvestment. This can either be paid for by users or by taxpayers. The Governor also observed of this that 'analytically, it is best thought of as a one-time rise in prices, but it filters out over several years so we observe it as a higher rate of inflation in these parts of the CPI for a time.'[11]

The 'neutral' or 'normal cash rate

2.19 At previous hearings the committee has examined the RBA about the policy cash rate and, in particular, what the neutral level is. Interest rates are generally referred to as 'neutral' if they are not having an expansionary or contractionary effect on the economy. At the February 2007 hearing, Mr Stevens indicated that the then policy cash rate of 6¼ per cent was 'mildly on the restrictive side of neutral.'[12]

2.20 At the current hearing, Mr Stevens noted that the policy cash rate of 4¾ per cent is slightly above normal. The neutral level is lower in November 2010 compared to February 2007 because market rates are higher and the RBA takes market rates into consideration when setting the policy cash rate. The Governor stated:

> What we are saying today is that, because the margin in the cash rates and the rates people actually borrow at has risen, we calibrate what we think of as normal, at least while that widening remains in place. I would have said that the 4.5 cash rate, which is clearly well below what was normal before, is for all intents and purposes normal in the world we are in now where the margins have widened because it delivered a mortgage rate or a business loan rate that was pretty much the average of the past 15 years. As of the last decision, we have moved above that a bit now. I think we would have to say that, particularly given the increase in loan rates is a bit higher than what we did, monetary policy settings are a bit above normal now.[13]

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11 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 35.

12 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 24.

13 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 19.

The multi-speed economy

2.21 There are sectors of the economy which are experiencing varying degrees of growth. The committee discussed the adequacy of other economic policy mechanisms, besides monetary policy, for dealing with a multi-speed economy. The Governor acknowledged that the RBA can set the overnight price of money. He also stated that while banks used to be subject to a greater degree of direction thirty or forty years ago, 'those direct controls were pretty ineffective'.[14] The Governor believed that other policy mechanisms, such as fiscal policy, are better suited to addressing distributional problems across disparate regions and that 'we best manage them not by trying to resist the forces for but rather by helping change happen more smoothly and helping the people who bear the cost through it'.[15]

Capacity constraints

2.22 Earlier this year Dr Lowe outlined in a speech that the main task for Australia is to expand the supply side of the economy, so that demand can grow solidly without causing inflation to rise.[16] During the hearing the committee asked Dr Lowe to elaborate on the key supply side deficiencies that the RBA is concerned about.

2.23 Dr Lowe advised that his point had been that living standards are usually determined by productivity. Over the last decade the growth in living standards has largely come from increases in the terms of trade. Dr Lowe explained 'we cannot expect the terms of trade to keep rising and we will inevitably go back to a period where growth in our living standards is going to be determined by productivity growth, or, to put it another way, expansion of the supply side'.[17]

2.24 In the subsequent discussion about the supply-side of the economy, the committee noted that the government was investing $27 billion taxpayer capital and $10 billion taxpayer debt in the National Broadband Network

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14 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 31

15 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 32.

16 Dr P Lowe, *Some Challenges For The Future*, Urban Development Institute of Australia National Congress (UDIA), Sydney, 10 March 2010; accessed on 4 February 2011 at http://www.rba.gov.au/speeches/index.html.

17 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 25.

and asked the Governor if there is a risk if the government funds capital projects that the private sector has rejected and what hurdles should such projects face. The Governor stated that 'I do not want to get into the NBN in any detail...[as] it is an area outside our core area of expertise'.[18] He went on to note that there probably are some projects that the private sector will not fund that ought to be done, but whether this is one of them would be another question. The Governor also stated that there ought to be proper cost-benefit analyses of all proposed projects.[19]

Labour market flexibility

2.25 The committee noted that the RBA had previously commented on labour market flexibility and sought the Governor's views about this, being concerned that decreased flexibility might have an inflationary impact.[20] The Governor responded by stating that the fact that unemployment had peaked below 6 per cent was unequivocally good news, but that it was very hard to tell what effect regulatory changes to the labour market might have.[21] The Governor stated:

> As to the regulatory changes, it is an important question to what extent these changes may have flexibility. It is very hard for me to tell. Many people that we encounter from a business background are quite concerned. It is not uncommon, of course, that when there has been a change for there to be uncertainty about how the new system will work. In some respects, I guess, one would have to say it is as much in the implementation and administration of it as in what the legal provisions themselves say.[22]

2.26 The committee asked the Governor about any knowledge that he might have about evidence or data concerning a possible connection between the legislative changes between 2004 and 2008 and enhanced productivity. In response to this, the Governor stated that:

> I think it would be hard to sustain an argument that a particular set of previous arrangements had led to a leap in productivity, based on the aggregate data. I would not want to have to make

18 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 26.
19 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.
20 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.
21 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.
22 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.

> that argument because the data are not that strong. The people who would defend those arrangements would not defend it on that set of figures, I guess.[23]

2.27 The Governor did not wish to make any judgement about the latest legislative changes on workplace relations, stating that he could not give any kind of precise date to look for evidence of the impact of legislation on productivity, but proposed instead that the key test would be 'whether we can go through a period of labour market tightness like we had three years ago and not see a materially more adverse outcome overall for the economy than we had then'.[24]

Fiscal stimulus

2.28 Following the committee mentioning that the fiscal stimulus was being withdrawn at a rate of about 1 per cent of GDP over the next financial year, the committee asked the Governor how confident he was that the economy would be able to offer employment for people who had been employed as a result of that stimulus. The Governor responded by stating that we simply cannot be certain about the so-called handover from public to private spending, but that various factors (including an increase in household income and increase in the terms of trade) suggested that we 'are getting...the handover from temporary public stimulus to the private'.[25] Dr Lowe confirmed that there has been a substantial increase in business investment.[26]

2.29 The committee was keen to explore the interplay between fiscal and monetary policy, in particular the impact of the structural budget deficit and the stimulus spending on interest and exchange rates. The Governor explained that this was an issue that had been covered many times before and went on to state:

> There are various shocks hitting the economy that affect demand. Some of them are offshore; some are domestic. There is monetary policy and, of course, there is fiscal policy which has an impact on final demand in the economy. As a matter of logic, it has to be true—doesn't it—that if there is a major change in the fiscal

23 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 14.

24 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 14.

25 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 19.

26 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 20.

> approach that has an impact on demand, and we are not talking trivial numbers but significant impacts, that has to affect, compared with the alternative, the outlook and therefore it has to affect the way we take our decisions.[27]

2.30 When pressed on what would have happened with the cash rate had there been less fiscal stimulus, the Governor stated that it would have been lower, but qualified that observation by noting that it would not necessarily follow that this 'would...be a better mix of policies'.[28]

2.31 During the hearing the committee mentioned a claim made by Chris Richardson of Access Economics, namely that a cut in the budget deficit of $13 billion would reduce interest rates by 1 per cent. The Governor responded to this by stating that significant fiscal tightening would indeed lead to an easing of monetary policy and a lower exchange rate.[29]

2.32 Following this, the committee raised the Non-Accelerating Inflation Rate of Unemployment (NAIRU) in connection with the Governor's opening statement that the economy was pretty close to full potential output. The Governor stated that, 'I do not want to make a prediction about the NAIRU if I can avoid it, because it is an analytical construct that is useful as a device but there is no statistic you can look up to see what it is; you can only observe it from experience.'[30] He also explained that the unemployment rate had been fairly stable at around 4 percent for a while, was now around 5 per cent, with a pick-up in wage growth that was no faster than was to be expected. We were close to potential output because 'we should not expect from here to be able to grow the economy very quickly over an extended period without getting into trouble'.[31]

Bank profits and bank competition

2.33 As previously noted, the banking sector's profits had inspired some controversy in the weeks leading up to the hearing. The committee was interested in drawing out any connection between the profits of the banking sector and their rates. During the hearing the committee referred to a chart showing the growth in profits of the Commonwealth Bank over

27 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 10.

28 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.

29 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 9.

30 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.

31 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.

the last ten years and asked 'how is someone, who has a mortgage with the Commonwealth Bank or one of these big banks, expected to feel when they see figures like the profits that banks continue to make and justification that banks need to raise their margins?' The Governor stated that:

> ...if we prepared a chart like the one you did there in absolute dollars for the profits of a whole bunch of large listed Australian companies, they would look very like that chart...if my choice is between banks with good profits and banks with no profits then I choose the former every time from an overall macroeconomic point of view...we need to be careful not to forget the size of the capital that is invested in these institutions, because you have to compare the two...[32]

2.34 The Governor elaborated on bank profits by pointing out that businesses need to ensure that the price of their products covers their costs, including the cost of equity. The Governor stated:

> ...but over time I think the thing that, maybe, has not had much focus is that the overall bank margins that we see today are a little higher than they were a couple of years ago but, compared to 10 or 15 years ago, are much lower, particularly in the mortgage base. That is a result of competition and efficiency gains, and most of those gains actually are still in place today, compared with, say, the year 2000 or the year 1995. It is quite different to then. We are arguing about a small backtrack a little way back up that curve but, when you look at that story in broad historical perspective, the overall net interest margins have been fluctuating between 2¼ and 2½ for about four or five years. There is not a lot of change.[33]

2.35 The Governor insisted that if the underlying question is whether mortgage holders are paying seriously higher rates than they should be, the answer is no, 'because we have pretty much offset the change in the margins by doing different things in the cash rate from what we would have done had the margins not shifted'.[34]

2.36 The Governor went on to point out that increases in lending rates were an effect of increased competition for funds by banks. The major Australian banks have increased their holdings of domestic deposits, in order to

32 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 8.

33 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 8.

34 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, pp. 8-9.

reduce their holdings from wholesale funding sources. The Governor stated that:

> It is pretty obvious why that happens and I think it is prudent of them to do it. What we have seen in the past several years is that those wholesale funding sources, which for some years up to the middle of 2007 were very available, very inexpensive and, apparently, quite reliable and quite stable, changed dramatically after the problems began in 2007 and especially after the Lehman failure in September 2008. I think every banker in the world and every supervisor concluded that it was a more unstable and risky source of funding than had previously been assumed and that banks, therefore, needed to change their funding mix more in the direction of things that could be expected to be stable. Our banks have done that. I cannot say that I regard that as something to regret. I think it is probably prudent. What that has meant is that there has been much more intense competition to raise funds by financial institutions in that space than there had been before.[35]

2.37 The committee also expressed an interest in the significance of the market share of the major banks, noting that while in 2007 the leading four banks accounted for roughly 68 per cent of household lending, by 2010 this had risen to 80 per cent. Dr Debelle advised the committee that for the last six months, the major banks' share of lending has been falling.[36]

2.38 The committee was concerned that the costs of loans were higher for small business than for households (concerns expressed in terms of possible 'price-gouging'). The Governor noted that lending to small business entailed higher risks than lending on the average home.[37]

Bank guarantee and moral hazard

2.39 The committee explored the $850 billion worth of guarantees that taxpayers provided to private banks, in order to examine the issue of moral hazard. The Governor advised that the Australian Government had made available a guarantee for wholesale funding and that while there had been some risk in doing this it was very well paid to take that risk and

35 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 7.

36 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 16.

37 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 17.

is currently earning about $1 billion a year in fees.[38] In addition, the stock of guaranteed liabilities is now closed. The Governor stated while that while these had reached around $170 billion or $180 billion, they are now falling; and the guarantee on deposits of over $1 million finishes at the end of October 2011.[39]

2.40 As for the question of moral hazard, the Governor stated that the intervention by the Australian authorities was 'pretty mild' by global standards. These interventions were necessary because 'the system faced a catastrophe in the absence of these measures'.[40] He advised that the outstanding issue is whether or not such guarantees should be issued in future. His view is that the government should aim to be in a position to say to banks, 'no, we are not going to give a guarantee and the system can cope with that.'[41]

2.41 When asked as to whether these guarantees formed a contingent liability for the Commonwealth, the Governor warned that this is a difficult matter to discuss publicly. He did not believe that any government would ever allow the system to collapse and noted that 'a bank failure...is not like the failure of any other business...which is why we have regulation that is much more intrusive on a bank than it is on your average industrial company'.[42] It is, therefore, probably impossible to eradicate the risk of moral hazard.

2.42 Continuing with its interest in government support for the banking sector, the committee expressed concerns that, since the RBA was the lender of last resort to institutions in difficulty, it might end up supporting insolvent firms. The Governor explained that there were essential differences between responding to a liquidity crunch by loaning money at high rates to a sound bank and supporting an insolvent one. While the former was appropriate, the latter was not. If there was a case to be made for rescuing an insolvent bank, that decision would have to be made by the government of the day.[43]

2.43 The committee raised the possibility of a trade-off between competition in the banking sector and system stability. In his response to this issue, the Governor explained to the committee that while banking competition is good to a point, it may yet lead to problems, such as when lending

38 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
39 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
40 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
41 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
42 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 24.
43 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 25.

standards fall to such an extent that the sector 'ends up lending money to people who really should not get it'.[44]

2.44 During the hearing the committee asked the Governor to elaborate on his views about competition and efficiency, especially in connection with the long-run drop in the net interest margin from 2000 to 2004 referred to in the statement on monetary policy.[45] The Governor answered by pointing out that the trend actually dates from 1990 or so, when non-bank competitors entered the mortgage market. The banks responded by containing their costs and improving their efficiency. As the efficiency of the financial system improved, credit became more available and prices fell.

2.45 The committee also asked about the role that the government's $16 billion injection into the residential mortgage-backed securities market is having on that market and whether it is helping those lenders recover. The Governor noted that the demand for mortgage backed securities suffered as a result of developments in America. Many of the sources of demand for such products have disappeared. The Australian Office of Financial Management (AOFM) purchases helped prop up demand. Dr Debelle supported this, stating that 'the AOFM has bought about one-quarter of the mortgage backed securities that have been issued over the past year or so'.[46]

Exchange rates and external trade

2.46 The link between the higher exchange rate and the suppression of inflation was examined during the hearing. The Governor explained that a higher exchange rate lowers the import prices for tradeable goods. The producers of export goods or services are price takers in global markets, so the domestic price goes down as the exchange rate goes up.[47] The purchasing power of importers goes up, enabling them to either enjoy higher margins or pass on price gains to customers. A transfer of income takes place via the exchange rate, which helps with holding down inflation. It also transfers some domestic demand off-shore, but makes it harder for many exporters.

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44 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 28.

45 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 42.

46 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 30.

47 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 36.

2.47 This does not have a large, negative, effect on the mining industry, because the price of iron ore has gone from $25 to $125 a tonne. However, exporters of education services suffer, because their foreign currency price has not gone up, so they must lower the Australian dollar price they charge in order to compete. As Ken Henry noted, it is almost a three-speed economy—there is the mining sector, the traded part of the economy that is not mining but is affected by the exchange rate, and the rest.

United States, China and the global economy

2.48 The ongoing crisis in European financial markets formed a critical feature of the context in which the hearing was held. In his opening remarks the Governor noted that there had been an increase in sovereign debt in a number of advanced countries and that the sustainability of this debt remains an issue for markets and policymakers alike. During the hearing the committee expressed its concern about the volatility and uncertainty in Europe and asked what possible consequence Australia might face. The Governor advised that the real question was not the fate of small countries like Ireland, but what would happen if the larger ones got into similar trouble. The Governor stated:

> ...for several years we will see periodic flare-ups of anxiety in Europe...What that means is that, for us, we balance the possibility that things could go pear-shaped in Europe— they may or may not; we will not know for sure for quite some time. I think in the US things are probably going to be okay, but they are not that strong. Of course, then we have Asia, and as every year it goes by it is clearer and clearer that the centre of gravity in the world economy is shifting there and we are very plugged into that, so we have to manage that. It is a complicated picture.[48]

2.49 The committee was interested to learn about the implications of steel production in key global markets for Australia’s terms of trade. The Governor explained that the rate of growth in some key markets (in particular those with steel-intensive built environments) is critical. Over the past decade and a half 300 million people in China have moved from rural areas to apartments in the cities and these apartments required steel, which in turn required iron ore. Thus, Chinese demand for steel keeps the global price of iron ore high. Dr Lowe added that India is just starting to urbanise on a comparable scale, but over the next 20 years we might

48 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 22.

reasonably expect 100 million or 200 million people in India to move from rural areas into city apartments. Demand for steel underpins our favourable terms of trade and is fundamental to our medium term prospects.[49]

2.50 During the hearing the committee examined developments in bank regulation under way within the G20. The Governor reported that: banks would have to hold more capital (in particular higher quality capital and more equity capital); there will be an average leverage ratio in addition to the Basel risk weighted capital standards; there will be liquidity standards designed to prompt more careful and more active management of capital, especially liquidity capital. It will be 2019 before these are all fully phased in.[50]

2.51 The Governor assured the committee that he did not anticipate any great difficulty for Australian banks in meeting the standards. The Governor stated:

> I do not think our banks will have very much trouble accumulating the additional capital they will need. They are quite close to the new requirements already in most cases. I might say that APRA has had a fairly conservative way of approaching these things all along. Our banks have tended to complain over the years that, if only APRA would measure capital the way the British do, we would all look better. But what is happening is that the way others are thinking about this is shifting closer to where APRA has been all along.[51]

2.52 According to the Governor, the principal issue for Australia is that the new standards require banks to hold more government securities, as a high-quality liquidity buffer, but there is not enough Australian government debt to do this.[52] Dismissing press reports that Australia would seek an exemption from the Basel standard, the Governor said:

> There will not be an exemption. Our system will meet the standard, but it will meet it in a different way to the average country in recognition of the fact that there just is not enough government debt in existence to meet it the normal way... I think

49 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 31.

50 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

51 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

52 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

> we will be able to come to a way of meeting the standard in a fashion that makes sense for Australia.[53]

2.53 The committee wanted to know how Australia's macroeconomic position compared to that of other developed countries. The Governor responded by stating that in respect to comparable countries, Australia had a modest downturn, that the fall in GDP here was relatively low and we returned back to growth more quickly. He also noted that it had been our smallest recession since World War 2, that unemployment rate peaked below 6 per cent and that while our public debt is higher than it was, it is low by the standards of developed countries.[54]

2.54 Asked directly if Australia had too much government debt, the Governor stated that: 'I have never felt in recent years that the size of the public debt that we have outstanding is a material problem for the country'.[55]

Household savings

2.55 The committee asked the Governor to elaborate on the increase in household savings referred to in the statement on monetary policy, in particular finding out if the trend is sustainable and what the consequences of this trend are likely to be. In his response the Governor replied that there has been a noticeable rise in the saving rate. The bank assumes that this trend will continue. The Governor hypothesised that 'there has been a kind of sea change in people's attitudes that we would expect to persist for a while'.[56] While this may be difficult for retailers, it increases competitive pressures on pricing, which assists with keeping inflation low.

ATM fees

2.56 During the hearing the committee sought advice on ATM interchange fees. The Governor advised that the bank had initiated some reforms. These included the abolition of interchange fees, disclosure of the fee at

53 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.
54 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.
55 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.
56 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 36.

the time that the fee is incurred and ensuring that the person who owns the ATM sets the fee.

2.57 The results have been that nobody pays a fee for using their own bank's ATM; almost everybody has access to a network that will give them a fee-free withdrawal; there has been a marked increase in the proportion of transactions done at own-bank and a corresponding fall in transactions at 'foreign' machines; the aggregate savings in fees resulting from all of this is about $120 million a year across the community, and an apparent increase in the number of ATMs available.[57]

Conclusions

2.58 Australia continues to enjoy economic conditions that would be a welcome relief to almost all other industrialised nations. Inflation remains within the targeted range and unemployment remains relatively low in historic terms, while the terms of trade has enhanced the global purchasing power of Australian households.

Craig Thomson MP
Chair
9 February 2011

57 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 21.

A

Appendix A — Hearing, briefing, and witnesses

Public hearing

Friday, 26 November 2010 – Canberra

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Dr Philip Lowe, Assistant Governor (Economics)
Dr Guy Debelle Assistant Governor (Financial Markets)

Private briefing

Wednesday, 24 November 2010 – Canberra

Mr Brian Redican, Senior Economist, Macquarie Bank

B

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

The Treasurer and the Governor of the Reserve Bank

30 September 2010

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

Since the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework. Since 1996, this framework has been formalised in a Statement on the Conduct of Monetary Policy. The inflation targeting framework has served Australia well and is reaffirmed in the current statement.

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

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

Relationship between the Reserve Bank and the Government

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

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

New appointments to the Reserve Bank Board will be made by the Treasurer from a register of eminent candidates of the highest integrity maintained by the Secretary to the Treasury and the Governor. This procedure removes the potential for political considerations in the appointment process and ensures only the best qualified candidates are appointed to the Reserve Bank Board.

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

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

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

Objectives of Monetary Policy

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

a. the stability of the currency of Australia;

b. the maintenance of full employment in Australia; and

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

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

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

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

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

Transparency and Accountability

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

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. The Governor issues a statement immediately after each meeting of the Board, announcing and explaining the Board's monetary policy decision, and minutes of each meeting are issued two weeks later providing background to the Board's deliberations. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its quarterly *Statement on Monetary Policy* and *Bulletin*, have been crucial in promoting increased understanding of the conduct of monetary policy. The Reserve Bank will continue to promote public understanding in this way.

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

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

Financial Stability

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

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

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

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

C

Appendix C — Glossary of terms

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

labour force. The employed plus the unemployed.

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

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

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

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

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

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

natural increase. Excess of live births over deaths.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Source: Parliamentary Library and Reserve Bank of Australia