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Monetary policy and other issues

Overview

2.1 Since the committee's previous public hearing in August 2011, the focus of concern has been on the possible impact of sovereign debt problems in Europe. High levels of public debt in key nations, caused a 'palpable fear before Christmas that Europe was on the brink of some sort of very bad financial event'.[1] The period was characterised by a flight from risk with borrowing costs for major nations like Spain and Italy rising, but falling to their lowest level in more than 50 years for the United States and Germany.

2.2 The Governor of the RBA reassured the committee that:

> The anxiety has not gone away altogether—and nor will it, I think, for some time—but the worst has not happened. Financial markets, while hardly brimming with confidence, have recovered somewhat over the past couple of months. Banks are able to access term funding again, albeit at higher cost. High-frequency gauges of business conditions and confidence have stabilised over the past few months in Asia, in North America and in fact even in Europe. We have not seen the very steep fall in all these indicators that we saw late in 2008.[2]

2.3 The Governor explained the improvement in conditions as the result of the European Central Bank having stabilised financial conditions through addressing questions about the funding of European banks, as well as the

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1 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

efforts of European leaders to establish a stronger fiscal framework for Europe.[3]

2.4 The Governor emphasised that that the global situation remains mixed:

> If we look for things to worry about, we will certainly find them. That global figure has a very uneven composition and there are some countries, particularly in Europe, which will record very weak outcomes this year. Moreover, it is unlikely, I think, that any time soon we will get to a moment at which it can be said that these problems in Europe are now behind us. Most likely progress will be slow and there will be periodic setbacks and bouts of heightened anxiety. I think that is just the nature of these things.[4]

2.5 The Governor put this in context by pointing out that the global situation has not been consistent. While growth has slowed in Asia, it has not slumped. The US economy avoided a 'double dip' recession and has continued to grow. The US corporate sector has performed very strongly and looks set to make more rapid progress in the future. US corporations appear to have increased the rate at which they hire new staff.[5]

2.6 Despite the current international uncertainty, the fundamentals of the Australian economy are strong. Public debt and unemployment are low, underlying inflation is at the midpoint of the inflation target range, and we have a significant pipeline of business investment, particularly in the resources sector.

2.7 In relation to Australia's performance and economic outlook, the Governor stated:

> Our rate of unemployment has a 'five' at the front and the next digit is a small number. Inflation is about where we want it and our banks are strong. Our government finances, despite some pickup in debt in recent years, are that basically we are a AAA-rated country and rightly so—there are not that many of those. We are attractive to foreign investment. The government did not end up having to own any banks as a result of the crisis. There is a lot that is good about that picture. I do not wish in any way to be a Pollyanna and say, 'Look, it's the best of all possible worlds,'—it is not. We have issues, but it is actually a pretty reasonable performance compared both with our historical experience and

3 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 1.

4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 1-2.

5 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

> also with the vast bulk of other countries you might choose with which to draw a comparison.[6]

2.8 The RBA's central expectation for the next two years is for growth to closely follow the trend and for inflation to be close to the target. The Governor emphasised that the drivers of growth in the Australian economy have changed recently. The Governor commented that 'we have spoken at length in the past about the terms of trade, the resulting investment boom, which is still building and has somewhat further to go yet and which will take the share of business investment in GDP to its highest level in at least 50 years.'[7] The Governor also noted that household behaviour has changed with people saving more and spending less.[8]

2.9 The overall effect is that while the economy has experienced average growth, this has been distributed unevenly. There are sectors of the Australian economy which are experiencing average performance. Some are weak relative to the historical average, others stronger. The Governor acknowledged that:

> The bank is quite aware of those differences and the pressures that they bring to businesses and individuals. We also know that monetary policy cannot remove the forces that generate different paces of growth across industries or regions in the economy. We have to keep our eye on the overall performance of demand and prices. We are also acutely conscious that history may offer limited guidance in assessing the net impact of the very disparate and very powerful forces which are at work to an extent which has seen few historical parallels.[9]

2.10 For these reasons, the bank decided that the existing monetary settings were appropriate for our present condition and were 'about right for the moment.'[10]

2.11 The Governor was asked about the robustness and resilience of the Australian economy to respond to another significant downturn like the Global Financial Crisis in 2008. The Governor responded in the affirmative, declaring that:

> I think that in the banking sector we are probably in better shape than then because of the extent of usage of wholesale funding.

6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 4.

7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 2.

9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 2-3.

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.

> There is still a considerable amount of it, but it was smaller than it was then. Asset quality and capital is strong...I think we would be in good shape...we have as much capability as any country and more than most to respond to it.[11]

Forecasts for the economy

Forecasts for the global economy

2.12 Though sovereign debt remains an enduring problem in Europe, sentiment has recently improved in response to measures taken by the European Central Bank and European governments. Equity and commodity prices have risen, while bond yields in several European countries have fallen. Further work will be needed to ensure the sustainability of European public finances.[12]

2.13 Official forecasts for global growth have been revised down. Global growth is now expected to be below trend in 2012, though not as weak as in 2008–09. Much of the growth is expected to come from the emerging market economies, especially in Asia. A broadly synchronised fiscal consolidation throughout the developed economies is expected, as households and financial institutions deleverage. This reduces growth, so unemployment in these countries is not expected to fall in the immediate future.[13]

2.14 Much of Europe appears to be in recession, though the US economy has picked up following a soft patch in mid 2011, with unemployment falling and an apparent improvement in the housing sector. Weaker exports have caused growth to slow in East Asia. Both growth and inflation has fallen in China, as per the intention of official policy there. The Chinese authorities have been trying to contain property prices, with some success.[14]

2.15 Though the spreads on many European bonds remain elevated, they are lower than in late 2011. In Australia, yields on 10-year government bonds have recently fallen to 50-year lows, following significant purchases by

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11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 4.

12 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1. This is available electronically at: http://www.rba.gov.au/publications/smp/2012/feb/pdf/0212.pdf

13 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.

14 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.

non-residents, including sovereign asset managers. The Australian dollar continues to appreciate against major currencies and is currently just below the multi-year peaks reached last year.[15]

2.16 Following concerns over the European banking system in much of 2011, there was very little bank debt issued for sale. Rates of issuance have improved recently, but spreads on bank debt are much higher than in mid 2011. Some large corporations now raise funds in the capital markets more cheaply than banks with a higher credit rating. This has had an effect on Australia, where the banks' overall cost of funding relative to the cash rate has risen.[16]

Forecasts for the Australian economy

2.17 Commodity prices after falling over the second half of last year have recently risen. The price of iron ore has increased thanks to strong demand from China, despite the fact that global steel production has fallen. Thanks in part to geopolitics, energy and commodity prices have remained at high levels.[17]

2.18 Australia's terms of trade reached a record high in the September quarter, but declined in the December quarter of 2011. Australia continues to grow at a moderate rate. GDP is estimated to have increased by around 2¾ per cent over 2011. This is a little below average. Conditions vary across industries, as the economy experiences structural change as a response to high commodity prices and the exchange rate.[18]

2.19 Real incomes for Australia have risen as a result of the terms of trade, but the effects are unevenly distributed. The various measures of business conditions and confidence are now at, or just below, average levels.[19]

2.20 Business credit has also increased a bit during the second half of 2011 after it had fallen in the previous year. Credit conditions remain tight for commercial property. Investment in the resources sector is expanding rapidly.[20]

2.21 The RBA expects that next year the level of business investment in Australia will reach its highest level, relative to GDP, in at least half a

15 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.
16 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 1.
17 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
18 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
19 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.
20 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

century. Yet another large liquefied natural gas (LNG) project has recently received final investment approval, bringing the total value of LNG projects approved or under construction to around $180 billion.[21]

2.22 Conditions in many other sectors remain subdued, as a result of the exchange rate, weak consumer demand, the fall-off in public investment and limited building construction. The Queensland coal industry has not fully recovered from the floods of early 2011. Retail spending remains relatively weak. Household consumption has increased, with the household saving ratio at the lowest for two decades. Prices declined a little over 2011. Building construction remains relatively weak.[22]

2.23 Private sector wage growth is currently at its medium-term average pace while public sector wage growth slowed during 2011. Apart from the mining industries, there is little evidence of wage inflation. The most recent inflation data met the RBA's expectations, with underlying inflation around ½ per cent in the December quarter. On a year-ended basis, underlying inflation is at 2½ per cent, which is the midpoint of the medium-term target range, with the outcomes over the second half of the year lower than in the first half.[23]

Table 1 RBA Output growth and inflation forecasts

		Dec 2011	***June 2012***	***Dec 2012***	***June 2013***	***Dec 2013***	***June 2014***
GDP		2¾	3½	3-3½	3-3½	3-4	3-4
CPI		3.1	1¾	3	3¼	2½	2½-3
Underlying inflation		2½	2¼	2¾	2¾	2½	2½-3
CPI inflation excl carbon price		3.1	1¾	2½	2½	2½	2½ -3
Underlying inflation excl carbon price)		2½	2¼	2½	2½	2½	2½-3
Year-average							
		2011	***2011/12***	***2012***	***2012/13***	***2013***	***2013/14***
GDP growth		2	3¼	3½	3-3½	3-3½	3-4

Technical assumptions include A$ at US$1.07, TWI at 78, and Tapis crude oil price at US$125 per barrel.
Sources: ABS; RBA

Source *Reserve Bank of Australia, Statement on Monetary Policy, February 2012, p.67.*

21 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

22 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

23 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

2.24 The headline CPI over the year to December 2011 was 3.1 per cent. Once again, the outcome was affected by banana prices, which subtracted around 0.3 percentage points from inflation in the quarter as supply recovered from Cyclone Yasi. The price of tradables excluding food, fuel and tobacco fell by ½ per cent in the quarter, with falls in the prices of cars and major household appliances. Most other tradable items recorded smaller price declines than recently, which may reflect higher world prices. The prices of non-tradables rose steadily by 0.9 per cent in the quarter and by 3¾ per cent over the year. There were above-average increases in the prices of a range of non-tradables including rents, communication, restaurant and takeaway meals and childcare. Inflation in non-tradables has slowed a great deal since 2008, so further moderation may be required for overall inflation to be consistent with the midpoint of the target range once the effect of the appreciation of the exchange rate on tradables prices falls off.[24]

2.25 The Bank's central forecast remains for around trend GDP growth over 2012 and 2013. Demand is expected to overtake output, with a significant share of the growth in investment met through imports. Employment growth should remain subdued in the near term, with a small increase in the unemployment rate forecast over 2012, after which the rate of unemployment rate will begin to fall over the later part of the forecast period.[25]

2.26 The growth in investment in the resources sector should remain very strong. This is expected to have positive spin-offs for other sectors, although the high exchange rate, fiscal consolidation and reduced consumer spending will mean that overall growth outside the resources sector will remain below trend.[26]

2.27 Europe remains a source of uncertainty. Sovereign debt remains a major problem. Should the debt situation grow any worse, Europe would experience a severe recession, with implications for the global economy. With Australia's scope to adjust macroeconomic policy, the flexible exchange rate and strong banking system, Australia is well placed to deal with that eventuality, should it occur. If this risk were realised, Australian growth would be poorer than the current central forecast.[27]

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24 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

25 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

26 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

27 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 3.

2.28 The inflation scenario has changed very little since the August hearing. In underlying terms (and excluding the introduction of the price on carbon) inflation should remain at about the midpoint of the target range for most of the following few years, before increasing late in the forecast horizon as the disinflationary effects from the exchange rate appreciation diminish. Headline inflation should fall below underlying inflation in the near term once the earlier spike in fruit prices continues to fall off. From the September quarter 2012, inflation will be stimulated by the introduction of the carbon price, which is expected to add 0.7 percentage point to headline inflation and around ¼ percentage point to underlying inflation over the following year. This scenario assumes both a modest slowing in domestic cost pressures and that the introduction of the price on carbon does not lead to second-round effects through higher margins or wage claims.[28]

2.29 Since the inflation outlook improved late last year, the Board lowered the cash rate by a cumulative 50 basis points at its November and December meetings, after having maintained a mildly restrictive stance of monetary policy through most of 2011. For the most part, these reductions in official interest rates were passed through to borrowers, so that most lending rates are now close to their medium term averages. At its February meeting, the Board decided to hold the cash rate steady at 4.25 per cent, given that the central forecast was for close to trend growth in GDP and inflation being close to target. The current inflation outlook allows for easier monetary policy should demand conditions weaken substantially. The RBA will continue to monitor information on economic and financial conditions and the Board will adjust the cash rate as required to best encourage sustainable growth and low inflation.[29]

Banking sector

2.30 As part of the discussion about interest rates, the committee noted that there was a lot of criticism of banks and their profits. The committee asked the Governor if the RBA thought that banks were either over-profitable, simply passing on genuine costs or possibly reacting cautiously. The Governor stated:

28 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 4.

29 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 4.

> ...if I had to choose between unprofitable ones and profitable ones, I would choose the latter...we do not want banks that cannot earn a good return.[30]

2.31 The Governor further elaborated by pointing out that profitability was a relative term, meaningful only in connection with a particular benchmark. The Governor explained that in terms of the rate of return on equity over the last twenty years, bank profits had been broadly in line with the listed company sector in general in Australia. Using that comparator, bank profits were not excessive, though there are other comparators that one could use.[31]

2.32 The committee speculated that if Australian banks were indeed over-profitable then foreign banks would be attracted here so as to take advantage of local conditions and asked the Governor if there was any evidence of this actually happening. The Governor replied that it 'is a reasonable assertion that, if it is really, really profitable here, other players will want to find some way of getting their hands on some of that profit'.[32] The Governor also advised that foreign competition within the domestic banking sector was synchronised with the credit cycle and the cycle of confidence. When global conditions are easy enough, foreign banks increase their Australian presence. When the cycle turns, the foreign banks withdraw to a degree.

2.33 The committee sought the Governor's opinion of the reaction by the banks to the most recent decision of the RBA board concerning the cash rate, when the banks increased interest rates on the grounds of increased funding costs, despite announcing record half-yearly profits. The Governor responded by noting that large institutions can be expected to make large profits and that there is nearly $200 billion of shareholders' money in the banking sector as a whole, of which $160-odd billion would be invested in the four large banks. The Governor teased out the issue by restating the question as 'what is the rate of return being earned by those shareholders on that $160 billion?' The Governor answered himself by noting that over the last twenty years the returns on earning are on average comparable to the returns available on the share market in general.[33]

30 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 3.
33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

2.34 Following a passing reference by the committee to the banks following the cash rate, the Governor explained that 'the period in which the banks followed the cash rate exactly was a rather unusual one historically...If you go way back, there was not such a lock-step pattern at all.'[34] According to the Governor the long term pattern is for credit spreads to shift and that since the crisis in Europe and the US began in 2007 they have, in fact, shifted substantially.

2.35 The Governor also explained that while the cash rate remains a powerful determinant on what banks charge, it is only one of a number of factors involved. Consequently, we should expect to see bank rates move independently of RBA decisions. This is not surprising, given the overall context.[35]

Cash rate

2.36 The committee was interested in teasing out the technical details of the relationship between the cash rate and market rates, in particular the extent to which this relationship was influenced by either cost increases involved in accessing capital markets. The Governor answered:

> What is the difference between those two things? The same level of profit means that if your costs increase then you want to recover that in the price of your product—any business does. I do not think there is any question that, relative to the cash rate, the costs of some term funding in wholesale markets has risen....So I think when people say those costs have risen that is true. I am not here to defend the banks; they can defend themselves. But most businesses seek to reflect their costs in the prices of their products, if they can, and that industry is no different in that respect.[36]

2.37 The committee wished to pursue the issue of bank costs further and asked the Governor if he thought that Australian banks paid a fair price for funds from the global credit market. The RBA affirmed that Australian banks, given their credit rating, paid the right price. The RBA further explained that while there were Australian corporate institutions that might be able to borrow at cheaper rates overseas than Australian banks

34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 18.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 8.

could, Australian banks held their own when compared to overseas banks with comparable credit ratings.[37]

2.38 The committee was interested in the structure of the banking sector and the relationship this might have with interest rates, asking the Governor if Australians might gain cheaper access to credit if the market share of the big four were taken by more banks. The Governor responded by saying that he did not think they would and that 'it is not obvious to me that the market share of those four particularly raises the cost of funding for the overall system'.[38] Moreover, the Governor observed that in most countries there were only a handful of banks. The United States was unusual in being an exception to that rule.

2.39 The committee noted that one of the strengths of the US system is its venture capital market and asked the Governor directly if he thought that the difficulty of accessing credit for risky enterprises was an impediment to productivity growth in Australia. The Governor responded by saying that he was not sure and was unable to estimate how large the venture capital market was in Australia. The RBA advised the committee that the Australian venture capital market has been small and that attempts to enlarge this over the last generation or so have failed. The RBA commented that, 'no-one has ever really been able to come up with a coherent explanation as to why that is the case.' [39] The Governor also made the point that while Australia does not have a market for corporate debt like that of America, very few countries do.

Bank guarantee

2.40 The committee examined the RBA on the government's bank guarantee. The Governor explained that the government guarantees bank deposits by way of what it calls the financial claims scheme and that the cap on this guarantee was reduced from $1 million to $250,000 a couple of weeks before the current hearing.[40]

2.41 In the event of a bank failure, depositors would get their money very quickly up to the capped amount ($250,000) which would cover almost everyone. Were an institution put into administration by the Australian

37 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 8.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 14.

39 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 14.

40 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 18-19.

Prudential Regulation Authority, the financial claims scheme would come into effect. The institution's assets would be recovered to reimburse creditors, but the scheme would assure depositors of up to $250,000. Monies paid out to individuals under the guarantee would be recovered from funds from the wind-up of the bank. In the Governor's opinion, 'it is extremely unlikely that the scheme would fail to be repaid in that process'.[41]

Structural adjustment

2.42 The committee noted concerns about differential impact of monetary policy on different sectors of the economy and different regions of Australia. The Governor explained that while there were indeed differential impacts, these had been relatively muted by historical standards, most probably by the fact that the economy was more flexible than it had been in the past. The Governor warned that we need to take care not to overstate things. He also pointed out that monetary policy was a national policy that relied on a single instrument, a single currency.[42]

2.43 The Governor then proceeded to put the situation in the wider, global context:

> What has happened is that there has been a major shift in relative prices, so the prices for natural resources and energy are way up; the prices for manufactured products and some services are down. There is nothing anyone in Australia has done to make that occur; it is a global phenomenon and there is actually nothing we can do to make it go away. It is a feature of the global economy that has occurred. In aggregate, for our country it is an enriching thing because we have such a large natural endowment of natural resources and energy, but also, because it is a relative price shift, that will occasion pressure to change the structure of the economy. There are no two ways about that. Monetary policy cannot make it go away. I do not actually think any policy can make it go away.[43]

2.44 The Governor also advised that to assist with economic adjustment other policy areas would have to be considered, as monetary policy simply cannot do anything about relative prices. He insisted that every other

41 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 19.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

43 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

country in the world has to adjust to this shift in prices. While the adjustment process is not easy, it can be a positive opportunity because of Australia's endowment of natural resources.[44]

2.45 The committee referred to ongoing debate about the pros and cons of currency intervention, citing the example of Switzerland, and asked the Governor if such intervention was a good idea.

2.46 The Governor responded by explaining the details of Switzerland's circumstance, pointing out that Switzerland is experiencing a deflation in consumer prices and that the exchange rate forces at work there were stronger than those which Australia must deal with. The Governor stated frankly that the bank had not attempted any comparable intervention to hold down the value of the Australian dollar because he was not confident that such a move would be effective. The Governor did not rule out such intervention on principle, but once again insisted that we have to see how things develop.[45]

2.47 The committee asked the Governor to comment on sectoral performance. The Governor advised that tourism in some regions, especially Queensland, were suffering, though Sydney hotels appeared to be quite strong. He further elaborated by noting the difficulties of trade-exposed manufacturing and some areas of the construction industry as being weak.[46]

Investment boom

2.48 The committee asked the Governor to outline the key factors that have an impact on business investment and, in particular, the issue of business uncertainty. The Governor responded by saying that the biggest single factor would have to be the shift in relative prices. The Governor noted that the share of business investment to GDP was now as high as it has ever been in the last fifty years. This situation has been brought about by the high price of the natural resources that Australia has so much of – iron ore, coal and gas. The Governor noted that with respect to the rest of the economy, which was not involved with resource extraction, the level of

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

45 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5.

46 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 7-8.

business investment was not high, neither was it problematically low. It was all simply a part of the adjustment to the shift in relative prices.[47]

2.49 A brief discussion of the implications of uncertainty ensued, with the committee referring to an article published on the date of the hearing, in which Dom Argus called for greater certainty for business.[48] This article came in the wake of similar calls by business leaders and the committee sought the Governor's input on this issue. The Governor stated:

> ...if it were true that there was a serious perception of elevated sovereign risk for Australia, I do not think we would be seeing the appetite for Australian dollar denominated Australian government debt that we have seen, which has been quite strong lately. At least that factor leads me to be wary of drawing strong conclusions about sovereign risk. There are other elements where there can be uncertainty, over regulation and so on, and that maybe what business people are referring to. I am not really convinced that sovereign risk is a major issue at least at present.[49]

Productivity

2.50 The committee explored the issue of productivity, with a member referring to an unspecified recent comment by the Business Council of Australia that Australia was becoming a high-cost low-productivity country. The Governor stated:

> I think the facts on productivity are that, pretty much whichever way you cut it, we had a period of quite good growth in productivity in the decade up to sometime in the early 2000s—maybe around 2002 or 2003—and since then, at least as I eyeball the figures, the trend rate of growth of productivity has slowed materially... There is no question that rising productivity is really fundamentally the only source of higher living standards available to a community, particularly one that starts with reasonably full employment overall, as we do. From here, rising output from our

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47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 5-6.

48 "Lucky country 'at risk' amid chaos, says Don Argus", Annabel Hepworth and Scott Murdoch, *The Australian*, 24 February 2012. The article is available electronically at: http://www.theaustralian.com.au/national-affairs/lucky-country-at-risk-amid-chaos-says-don-argus/story-fn59niix-1226280006022

49 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 6.

> capital stock and our workforce is really the only source of higher standards of living.[50]

2.51 In the course of examining productivity, the committee sought the Governor's views on whether the level of industrial disputation is considered by the RBA and flowing through to its decisions. The Governor stated that he could not recall industrial relations per se ever being raised in a serious way when setting the cash rate. However, he acknowledged that the bank did take careful note of the effect of wage growth on costs, stating that the bank monitored aggregate data on this. The Governor also explained that wage growth might make it harder to reach the inflation target, but so far this was not the case. The Governor made the caveat that if the rate of wages growth were to accelerate materially from recent levels, he would be concerned.[51]

2.52 The Governor advised the committee that though improving productivity was far from easy, he did expect an improvement in productivity in the foreseeable future. In the Governor's words:

> I think it is a reasonable forecast to make, that there will be some improvement. I do not have in my head the extent of the pick-up that we are contemplating. But the reason I think that that is likely is that we are, as we have been saying earlier, in a period of structural change. I think it has probably accelerated in recent times. It would normally be expected that that results in an acceleration in productivity improvement. It is not an easy process for the firms doing it. Sometimes when we talk about productivity I think there is a tendency in community discussions to think of this as a very nice, soft, wonderful concept and that we can just dial it up, but it actually does not work that way; it works by firms, managements and workforces grinding out difficult changes to the way they do things every day. [52]

2.53 The Governor also insisted that productivity needed to be understood within the wider context of wage growth and other costs and that overall productivity was not simply a matter of labour productivity, but of capital productivity as well.[53]

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 6.
51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 7.
52 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.
53 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

Labour market

2.54 The unemployment rate is about 5¼ per cent. Employment growth has slowed, while employment has declined in several industries including manufacturing, retail and real estate, but increased in others such as mining. The increased demand for labour was mostly met by existing employees working longer hours. The forward-looking indicators suggest moderate growth in employment ahead, although the RBA's liaison suggests that some firms seek greater certainty in their environment before hiring additional workers.[54] During the hearing, the RBA was asked what might happen to unemployment over the coming year. The RBA advised that unemployment will rise then start to decline. The RBA stated:

> In our central forecast we have the unemployment rate drifting up probably to around 5½ per cent some time over the course of the next year and then gradually coming down a little bit. What we detect at the moment when we talk to business is some reticence about hiring. In 2010 businesses were prepared to hire on the prospect of stronger demand. Now they want to actually see the stronger demand before they commit to taking on extra workers. That is attributing to the softness in the labour market. Over time, if our view about the demand strength in the economy turns out to be true, I think businesses will feel that they have the confidence to actually go and hire workers a bit more aggressively again than they have over the past year and so the unemployment rate will then drift down a bit. But most of the time over the next two years I think we will be sitting with the unemployment rate between five per cent and 5½ per cent.[55]

2.55 The committee asked the RBA whether it was concerns by the business community that flexibility of the labour market was impacting on their decision to hire new workers. In response to this, the RBA stated:

> I do not think that is the major issue here. I think it is global uncertainty. It was not that long ago that we had the IMF talking about the possibility of another 1930s moment. That is typically not an environment in which businesses feel emboldened to go and hire workers on the prospect of stronger demand. There are obviously a whole range of other factors at play here, but I think the first order one is really the global environment. If that can

54 Reserve Bank of Australia, *Statement on Monetary Policy*, 9 February 2012, p. 2.

55 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript*, 24 February 2012, p. 9.

> settle down and private demand in Australia grows like we think it will, I think we will see the employment growth come back again.[56]

Global uncertainty

2.56 The committee discussed the prospect of further difficulties in Europe and what impact this might have for the Australian economy. The Governor referred to Greece and the assistance package now in place. He explained that what needed to be done was pretty clear, but nonetheless difficult, on account of the fiscal problems at work.[57] He acknowledged the risk that reform might impede growth. The Governor also explained that a key issue was the need for European banks to develop stronger capital positions and that this need to be accomplished by attracting capital rather than by deleveraging. Most importantly of all, the Governor insisted that there needed to be supply-side growth and positive reforms. The Governor stated:

> ...you have 27 countries in the EU all trying to do this in some kind of reasonably coordinated fashion. This is no easy project, but that is what they are attempting and we all have an interest in them managing to pull it off...I think some credit should be given for some progress having been achieved recently. There is a long way to go, and during that time we will periodically at these hearings still be talking about what happens in Europe. I think we will be talking about that for a few years, really.[58]

2.57 The committee sought the Governor's views on how he thought the situation in Europe was likely to develop over the next six to twelve months, focusing on inflation/deflation issues. The Governor responded by stating that Europe was in a down-turn, which, at an aggregate level, would probably be a deep one. The attempted recuperation of the Greek economy, and those of several other peripheral economies, would continue, albeit with 'flare-ups every few months'.[59]

56 Dr Phillip Lowe, Deputy Governor of the RBA, *Transcript*, 24 February 2012, p. 9.

57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

58 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 11.

59 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 20.

2.58 Regarding inflation versus deflation, the Governor characterised the question as being if the unusual central bank action would ultimately be deflationary. The Governor said that the situation was complex:

> I think it will be a tricky balance to manage, with very high levels of public debt, unusually low interest rates for a long period and bloated balance sheets. It will be a long, tricky way back to normal from there. In that sense, it is not that surprising that some people worry about the potential for longer run inflation. I think one can understand why the central banks will need to manage this process very carefully.[60]

2.59 The RBA noted that the real surprise was the failure of inflation rates to fall even more in the United States and in Europe. In the US unemployment has been at 10 per cent for a while and it is now a bit above eight per cent, while in Europe it is above 10 per cent. Yet inflation is between one and two per cent. Just why this is so is not entirely clear but developments in commodity prices, which have trended up in recent years, have played a part. Consequently, the RBA noted that, 'in the short term the risks are probably on the downside of inflation but in the medium term on the upside'.[61]

Inflation

2.60 The committee noted the strength of inflation in non-tradables when Australian growth since 2008 has been below average and households have begun to increase their rate of saving. The Governor explained that there had been a number of steep rises in utility prices, which he did not expect to get even steeper on a percentage change basis over time. The bank forecasts that over time this will slow down, assuming that there is some improvement in productivity growth over the period. In the Governor's view, that is a reasonable assumption.[62]

2.61 The committee, referring to work on the RBA's perceived priorities published by a pair of academic economists in 2012, sought the Governor's advice on the bank's dual mandate (to target inflation and output simultaneously), in particular if the bank had some kind of formula

60 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 21.

61 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 21.

62 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 10.

for weighing the relative importance of its competing priorities.[63] The Governor stated that he did not have any precise weighting in mind when deliberating on interest rates. The Governor explained that the inflation targeting policy of the bank allowed them to address both priorities simultaneously in a way that worked well. The RBA explained that this sort of analysis was not necessarily all that meaningful, as it was simply not possible to map the variability of inflation and output with precision.[64]

2.62 The Governor characterised the bank's position on the dual mandate by stating:

> ...we are not what Mervyn King used to call 'inflation nutters' to the extent that we give no regard to the real economy at all, but nor are we so intent on trying to finetune real economic activity that we let the medium-term path of inflation drift seriously off course. So we should not be in either of those extreme positions, and we are not. I do not know whether one-third, two-thirds is the correct assessment of what we are doing. I think there is some substance to saying we are not in either of the corner solutions, and I think it is appropriate that we not be.[65]

2.63 The Governor explained that the current inflation targeting framework had been in place for about twenty years and was working well, with successful results for inflation and output.[66]

2.64 The committee noted that during the last mineral boom the unemployment rate was closer to four per cent, albeit with inflation outside the target band, and asked the Governor if it was reasonable to estimate that the minimum sustainable level of unemployment is now closer to five per cent? The Governor stated:

> I am not doctrinaire on unemployment rates, because there are various reasons they can shift...I do not quite feel comfortable with the notion that there is a hard barrier for unemployment—that it is a particular number and you must not go below or above that. I

63 Mr Glenn Stevens, Governor of the RBA, Transcript, 24 February 2012, p. 11. The work in question was a paper by Glenn Otto and Graham Voss, 'What do the RBA's Forecasts Imply about its Preferences over Inflation and Output Volatility?', *The Economic Record*, vol. 87, No 279, December, 2011 pp. 509-524; the article is available electronically at: http://onlinelibrary.wiley.com/doi/10.1111/j.1475-4932.2011.00763.x/pdf

64 Dr Guy Debelle, Assistant Governor (Financial Markets), *Transcript*, 24 February 2012, p. 11.

65 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.

66 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.

> think we should be a little bit reluctant to be too doctrinaire about numbers.[67]

Governance

Securency and Note Printing Australia

2.65 At the previous public hearing on 26 August 2011, the committee sought advice from the RBA on the timeline and actions taken in regard to the bribery allegations surrounding Securency and Note Printing Australia. The committee returned to this subject, seeking details from the bank on developments since the last hearing.

2.66 The Governor advised the committee that a number of criminal charges had been laid against individuals and the companies involved.

2.67 When asked by the committee if, with the benefit of hindsight, the bank would have done things differently, the Governor answered:

> That is a question I ask myself. With these things still all unfolding, it is possibly not the right moment today in a public forum to give a considered and final answer to that...I think that since the allegations about Securency emerged in 2009 the way the bank has responded to that has been correct and the way the company has responded has been correct.[68]

2.68 In May or June 2009 the Governor briefed both the Treasurer and the then Prime Minister orally on the allegations regarding Securency and Note Printing Australia. In June 2010 the Governor on his own initiative wrote a letter to the Treasurer outlining the details of the case.[69]

2.69 The Governor also clarified the role that an individual staff member of Note Printing Australia played in relaying intelligence about developments with the case. After receiving an oral briefing on these developments, the then Deputy Governor requested that the staff member make a 'written statement on the matter which was available to the Freehills people that did the investigation in 2007.'[70]

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67 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 12.

68 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 16.

69 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, p. 17.

70 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 24 February 2012, pp. 23-24.

Conclusion

2.70 Australia continues to enjoy near-ideal conditions by international standards. The fundamentals of the Australian economy are strong. Public debt and unemployment are low, underlying inflation is at the midpoint of the inflation target range, and we have a significant pipeline of business investment, particularly in the resources sector.

2.71 While banking profits and market interest rates continue to provoke comment, the banking sector as a whole appears resilient and robust. As such, it provides the Australian people with a degree of assurance in a time of heightened global uncertainty.

2.72 Over the medium-term monetary policy is expected to meet the goals of its long-standing inflation target, with inflation remaining within the 2 to 3 per cent band.

Julie Owens MP
Chair
14 March 2012