COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS

Reserve Bank of Australia annual report 2018

FRIDAY, 9 AUGUST 2019

CANBERRA

BY AUTHORITY OF THE HOUSE OF REPRESENTATIVES

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS

Friday, 9 August 2019

Members in attendance: Dr Aly, Mrs Archer, Mr Bandt, Mr Laming, Dr Leigh, Ms Payne, Mr Tim Wilson.

Terms of Reference for the Inquiry:

To inquire into and report on:

Review of the Reserve Bank of Australia Annual Report 2018

The Standing Committee on Economics, which can inquire into and report on any annual reports referred to it by the House of Representatives, has agreed to undertake an inquiry into the 2018 Annual Report of the Reserve Bank of Australia.

WITNESSES

BULLOCK, Ms Michele, Assistant Governor (Financial System), Reserve Bank of Australia

DEBELLE, Dr Guy, Deputy Governor, Reserve Bank of Australia

ELLIS, Dr Luci, Assistant Governor (Economic), Reserve Bank of Australia

LOWE, Dr Philip, Governor, Reserve Bank of Australia

Committee met at 09:31

CHAIR (Mr Tim Wilson): Good morning everybody. I declare open this hearing of the House of Representatives Standing Committee on Economics and welcome representatives of the Reserve Bank of Australia here this morning, as well as members of the public and the media—and we have both.

Since the RBA appeared before the committee in February 2019, during the previous parliament, there has been some activity on the monetary policy front. The RBA has eased monetary policy by 50 basis points, to one per cent, following the RBA's decision to cut the cash rate in June and July. At its meeting on Tuesday, the RBA decided to leave the cash rate unchanged at one per cent. Commenting on the decision to keep rates on hold, the RBA governor said:

> The outlook for the global economy remains reasonable.

However, he also noted:

> … the increased uncertainty generated by the trade and technology disputes is affecting investment and means that the risks to the global economy remain tilted to the downside.

We acknowledge this is also a significant shift from where we were at the end of last year.

The governor reported that Australia's economic growth over the first half of 2019 has been lower than earlier expected but is expected to strengthen gradually from here. He said:

> The central scenario is for the Australian economy to grow by around 2½ per cent over 2019 and 2¾ per cent over 2020. The outlook—

the governor said—

> is being supported by the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, signs of stabilisation in some housing markets and a brighter outlook for the resources sector.

In relation to the inflation outlook, the governor said the inflation pressures 'remain subdued across much of the economy'. He reported:

> The central scenario remains for inflation to increase gradually, but it is likely to take longer than earlier expected for inflation to return to 2 per cent.

The governor noted:

> In both headline and underlying terms, inflation is expected to be a little under 2 per cent over 2020 and a little above 2 per cent over 2021.

The governor further remarked:

> It is reasonable to expect that an extended period of low interest rates will be required in Australia to make progress in reducing unemployment and achieve more assured progress towards the inflation target.

These and other issues will be scrutinised by the committee today; however, it is noted that many Australians question the justification of a low interest rate environment for the foreseeable future, and some of these issues have been broadcast in the public sphere by members of the committee. The committee will examine the decisions of the RBA in the context of Australia's broader macroeconomic conditions and assess the RBA's confidence in current monetary policy settings, which aim to encourage growth and keep inflation consistent with the target over the coming years.

I remind you that although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House of Representatives. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament.

Dr Lowe and other members, thank you for coming. Would you now like to make an opening statement before we proceed to questions?

Dr Lowe: Good morning, everybody. Thank you for the opportunity to share our views on the Australian economy and the RBA's important public policy responsibilities. My colleagues and I strive for a very high level of transparency, and these hearings are an important part of the accountability process, so thank you for giving us this opportunity. Later this morning we'll be releasing the quarterly *Statement on monetary policy*, which will include our latest forecasts. What I'd like to do this morning is begin by highlighting the main points about the forecasts for output growth, the labour market and inflation, and then I'll turn to monetary policy.

Our central forecast is that the Australian economy will expand by 2½ per cent this year and 2¾ per cent over 2020. The growth forecast for this year has been revised down a little bit since we met six months ago, but the forecasts for next year are unchanged. The downward revision this year reflects weak consumption growth. It's become increasingly clear that the extended period of unusually slow growth in household incomes has been weighing on household spending, as has the adjustment in our housing market. Given this experience, the outlook for consumption continues to be the main domestic source of forecast uncertainty.

Even so, looking ahead, there are signs that the economy may have reached a gentle turning point. Consistent with this, we are expecting the quarterly GDP growth outcomes to strengthen gradually after a run of disappointing numbers. This outlook is being supported by a number of developments, including lower interest rates, the recent tax cuts, the depreciation of the Australian dollar, a brighter outlook for investment in the resources sector, some stabilisation in the housing market and ongoing high levels of investment in infrastructure. It is reasonable to expect that, together, these factors will see growth in the Australian economy return to around its trend rate next year.

The major uncertainty, though, continues to be the trade and technology disputes between the United States and China. These disputes pose a significant risk to the global economy. Not only are they disrupting trade flows, but they are also generating considerable uncertainty for many businesses around the world. Worryingly, this uncertainty is leading to investment plans being postponed or reconsidered. It's also now generating volatility in financial markets and has increased the prospects of monetary easing in many economies. This means that we have a lot riding on these disputes being resolved soon.

Turning now to the Australian labour market, the unemployment rate, at 5.2 per cent, is a little higher than when we met six months ago, and this is despite employment growth having been stronger than we had expected. What's happened is that increased demand for labour has been met with more labour supply, especially by women and older Australians. Reflecting this, a higher share of the Australian adult population is participating in the labour market than has ever been the case before. I want to be clear: this is very good news. But one of the side-effects of this flexibility of labour supply is that it's proving harder to generate a tighter labour market and so, in turn, it's been hard to generate a material lift in aggregate wages growth.

Looking forward, while some slowing in employment growth is expected, the central scenario is for the unemployment rate to move lower to reach five per cent again in 2021. If things evolve in line with this central scenario, it's probable that we will still have some spare capacity in the labour market for a while yet, especially taking into account underemployment. This means that the upward pressure on wages growth over the next couple of years is likely to be only quite modest and less than we were earlier expecting. Caps on wages growth in public sectors right across the country are another factor contributing to subdued wage outcomes. At the aggregate level, my view is that a further pick-up in wages growth is both affordable and desirable.

Turning now to inflation, the June quarter outcomes were broadly in line with our expectations, after a run of lower-than-expected numbers in earlier quarters. Over the year to June, inflation was 1.6 per cent, in both headline and underlying terms, extending the period over which inflation has been below the two to three per cent medium-term target range. The Reserve Bank board remains committed to having inflation return to this range, but it is taking longer than we earlier expected.

There are a few factors that I'd highlight as contributing to the low inflation outcomes over recent times. These are, first, the slow growth in wages; second, the ongoing spare capacity in the economy; third, various government initiatives to address cost-of-living pressures on households, which have reduced some prices; and, fourth, the adjustment in the housing market, which has contributed to unusually low increases in rents and declines in the price of building a new home in some cities. Working in the other direction, though, the drought and the depreciation of the exchange rate have been pushing some prices up recently.

Looking ahead, inflation is still expected to pick up, but the date at which it is expected to be back at two per cent has been pushed out again. Over 2020, inflation is forecast to be a little under two per cent and, over 2021, it's expected to be a little above two per cent.

I think at this point it's appropriate to turn to monetary policy. When we met with this committee in February, I indicated that I thought the probabilities of a cash rate increase and a cash rate decrease were broadly balanced. Following that hearing, the situation continued to evolve, and the board reduced the cash rate twice—at its June and July meetings—to a new low of one per cent.

A reasonable question to ask is: what changed? The answer is the accumulation of evidence that the economy could be on a better path than the one we looked to be on. The incoming data on wages, prices, GDP and unemployment all suggested that the Australian economy was some distance from running up against capacity constraints. It also suggested that the day at which inflation was comfortably back within the two to three per cent range was not getting any closer. Faced with this evidence, the board decided that it was appropriate to lower the cash rate, after having kept it unchanged for around 2½ years. It judged that a lower cash rate would boost jobs and help make more assured progress towards the inflation target.

In the current environment, easier monetary policy mainly works through two channels. The first is that it affects the exchange rate, which is now at the lowest level it's been for some time. The second is that it boosts aggregate household disposable income. I acknowledge that lower interest rates do hurt the finances of the many Australians who rely on interest payments, and the board has paid close attention to this issue. At the aggregate level, though, for every dollar the household sector receives in interest income, it pays well over $2 in interest to the banks and to other lenders. This means that lower interest rates do put more money in the hands of the household sector in aggregate and, at some point, this extra money gets spent, and this will help the overall economy. This is how monetary policy works.

At its meeting earlier this week, the board decided to leave the cash rate unchanged at one per cent. It judged that, after having moved twice in quick succession, it was appropriate to wait and assess developments both internationally and domestically.

As I mentioned earlier, there have been a number of developments that could be expected to support the Australian economy over the next couple of years. Determining with precision the combined effect of these developments is difficult. It's certainly possible that their combined effect will be greater than the sum of the individual parts. If so, growth would surprise on the upside. Of course, it's also possible that the concerning international developments and the ongoing weak growth in household incomes could see the economy underperform our central scenario. As has been the case for some time, the labour market will provide an important guide as to which path we're on.

It is, nevertheless, reasonable to expect an extended period of low interest rates in Australia. This reflects what's happening both here and overseas.

While we might wish it were otherwise, it is difficult to escape the fact that, if global interest rates are low, they are going to be low here in Australia too. When the global appetite to save is elevated relative to the appetite to invest—as it is right now—interest rates in all countries are affected. Our floating exchange rate does give us the ability to set our own interest rates from a cyclical perspective, but it does not insulate us from long-lasting shifts in global interest rates driven by saving/investment decisions right around the world, and that's the reality we face.

In the central scenario that I've sketched today, inflation will be below the target band for some time to come and the unemployment rate will remain above the level we estimate to be consistent with full employment, and while ever that remains the case, the possibility of lower interest rates will remain on the table. The board is prepared to ease monetary policy further if there is additional accumulation of evidence that this is needed to achieve our goals of full employment and inflation consistent with the target. Time will tell here.

As I have discussed on other occasions, if further stimulus to demand growth is required to get us to full employment and closer to the economy's capacity, monetary policy is not the country's only option. Monetary policy certainly can help, and it is helping, but there are certain downsides from relying too much on monetary policy alone.

One option is for fiscal support, including through spending on infrastructure. Spending on infrastructure not only adds to demand in the economy right now but, done well, it can boost the economy's productivity for the future. It can also directly improve the quality of people's lives by reducing congestion and improving services. At the moment, there are some capacity constraints in parts of the infrastructure sector, but these should not prevent us from looking for further opportunities to boost the economy's productive capacity and support domestic demand, and there's no shortage of finance to do this, with interest rates today the lowest they've ever been. This week, all governments in Australia can borrow for 10 years at less than two per cent, and some can borrow at much less than this.

Another option is structural policies that support firms expanding, investing, innovating and employing people. A strong, dynamic business sector is the best way of creating jobs and growing the overall economy. We will all do better if Australia is viewed as a great place to expand, invest, innovate and employ people, and a program of structural reform would help move us in this direction. It would also boost productivity growth, which over recent times has slowed noticeably. If this slowing is maintained it will become a serious issue, and as a society we'll have to make some difficult adjustments. So it's important that we think about the possibilities here, not just from a short-term perspective but also from a long-term perspective. I think this is really important.

Before closing, I'd like to mention a couple of other areas of the Reserve Bank's activities.

As you know, the Reserve Bank is the banker for the Australian government. As the government's banker, our systems process almost all of the government's payments and they receive almost all the government's revenue. Over recent years, we have undertaken very major investments in these systems. Two weekends ago, we finally turned off the mainframe computer on which we had been running these important banking services for the government for many, many years. Our new technology will allow us to continue providing a very high level of service to the Australian government and its agencies, and we're working with some of these agencies on innovative payment solutions. The Department of Human Services is already using our fast-payment options to get money quickly to those people who are in immediate need. The Reserve Bank is also continuing to invest heavily in the resilience of the systems that we operate that are at the core of Australia's interbank and fast-payment systems.

In other payments related work, the bank is continuing to look to ways to encourage faster development of the New Payments Platform, which allows us all to move money between bank accounts in real time 24/7. We have not been satisfied with the progress to date by the major banks and we want to see a faster pace of innovation that benefits both individuals and small businesses.

The bank's Payments System Board, in conjunction with the Council of Financial Regulators, is also reviewing the regulatory framework for money held in stored-value facilities and digital wallets. With so much innovation occurring in the world of digital payments, including by non-bank players, it's important that the regulatory regime in Australia is fit for purpose and appropriately balances competition and the protection of consumers. We are currently reviewing the regulatory regime in this area, and, as we complete this work, this issue may come before the parliament as we seek some changes to the arrangements. Another issue that we're working on that may come before the parliament is the strengthening of the regulatory arrangements that apply to the financial infrastructures that underpin Australia's financial markets.

Finally, we will be releasing the new $20 banknote on 9 October. There are currently around 170 million individual $20 notes in circulation, so, you can imagine, this is a big logistical exercise for us and the banks. But I am confident that Australians will enjoy spending these new, high-tech, highly secure $20 banknotes. I brought along a sheet today, hot from the printing press, that I'm happy to show you later on—one of the big sheets straight from the printing press.

Thank you. My colleagues and I value this opportunity, and we look forward to your questions.

CHAIR: Thank you very much, Dr Lowe. For clarity, I presume these are the same banknotes you showed us at our February hearing?

Dr Lowe: Yes, but today I have a big sheet. They are quite impressive as they come off the printing press.

CHAIR: I'm sure we'll all enjoy the opportunity to get a photograph of that. Thank you very much for your opening statement. In your opening statement, you said:

… it is difficult to escape the fact that if global interest rates are low, they are going to be low here in Australia too.

I guess my question for you then is: does this mean we are now in an environment where we're an interest rate taker, where we have very limited capacity to actually decide in comparison to decisions made by the reserve bank in the United States?

Dr Lowe: No, I wouldn't put it like that. You can think of this from two perspectives. One is a purely cyclical perspective. Because we have a floating exchange rate, that allows us to set the interest rate relative for the domestic considerations on output, employment and inflation. That's from a cyclical perspective. But there is a structural thing going on as well, and I think it is really important we understand this. At the moment, right around the world, there is an elevated desire to save and a depressed desire to invest. You see a lot of global savings because of demographic factors. There are a lot of savings in Asia. Many people borrowed too much in previous times and now they're having to repair their balance sheets, so they want to save a bit more. There is a lot of desire to save, and, right at the moment, not many firms want to invest. The reality we face is that, if a lot of people want to save and not many people want to use those savings to build new capital, savers are going to get low returns. The way the financial system works is that the central banks are the ones who set the interest rates, but we're really responding to this deep structural shift in the balance between savings and investment right around the world and there's not very much we can do about that. We can move our interest rates around this new structurally lower level, but we can't escape the fact that global interest rates are low.

CHAIR: Could you just expand on the extent to which you think an enthusiasm to save is brought about by economic conditions versus demographic shifts?

Dr Lowe: There are multiple things going on in many of the advanced economies. We have a lot of people who are ageing during the prime saving years of their lives, so they are saving a lot. We are seeing a lot of saving in Asia. The saving rates in China are particularly high. The social safety net is not very strong, so people save a lot there. We have seen governments and individuals borrow a lot in previous decades, and a time comes when you actually have to save a bit to pay back the borrowings of the past. I think that time is upon us in many countries. Also, people feel a bit nervous at the moment so they're saving more. Their income growth has slowed and they're not sure about what the future holds; that makes us all want to save a bit more. It is a global story, not just an Australian story.

On the investment side, investment intentions are weak. Concerningly, they have weakened in the last six months. I think that is very clearly linked to what's going on with the trade and technology disputes between the US and China. Investment is weakening, saving is high and it's not surprising that interest rates are coming down lower. The way to get out of this is to create an environment where firms want to invest again and people feel confident about spending. Central banks are really responding to these deep structural forces in the global economy, and we are no different to other central banks in that respect.

CHAIR: But doesn't this raise the question: to what extent does the Reserve Bank accept responsibility for any shift in consumer confidence as a consequence of lowering rates?

Dr Lowe: I'm not sure that the decision to lower rates has damaged consumer confidence. It clearly has upset some people in the community, but other people see it as a positive sign because it's contributing to the turnaround in the housing market, and I think that helps people feel a bit better. So I wouldn't accept the proposition that the cuts in interest rates have damaged and hurt consumer confidence right across the country. It's a mixed story.

CHAIR: In 2012, the RBA published a paper. This goes back to my question earlier about interest rates, particularly around demographic shifts. The paper states:

Households invest around two-fifths of their financial assets in interest-bearing assets … Deposits have grown strongly in recent years, although there has been no growth in interest-bearing securities.

A bit further down, the paper states:

… retirees have more interest-bearing assets than younger households, who are more likely to be in debt—

which is self-evident. Essentially it draws the conclusion:

Interest-bearing assets are expected to grow over time as the population ages.

Obviously that will therefore have an impact, in part, on those people who depend on them for their disposable income.

Dr Lowe: Yes.

CHAIR: Firstly, has the RBA done any significant research since the 2012 paper which I'm quoting, called 'Households' interest-bearing assets', by Ellis Connolly, Fiona Fleming and Jarkko Jaaskela? If so, in particular, how has that research gone on to inform the decisions around interest rate movements?

Dr Lowe: We continue to look at the distribution of income earned from interest and interest payments across the population through the various data sources that we have access to, so we have a strong continuing focus on that.

CHAIR: But, specifically, have you modelled that shift as part of—

Dr Lowe: I'm not sure that we have done further modelling there. We monitor the shifts that are going on. Luci?

Dr Ellis: With some of the relevant more recent research that we've done, while it is true that you expect that older households have more interest-bearing assets, not all of their assets are interest bearing, and you still do have a large fraction of equity and physical assets in the portfolios of older people. A relatively small share of older people have a significant fraction of their income being interest income. That's relatively unusual. The age pension and superannuation fund earnings are more important. One piece of research that I think is particularly pertinent to this is that, as the governor pointed out, the overall picture that we see of the effect of lower interest rates on household cash flows is a large positive. So, while almost every adult in Australia has some form of deposit account, most people have quite small balances. Very few people have balances that are large enough to form a significant fraction of their income. So, as the governor mentioned, the share of people who have debt and who have a positive effect on their cash flows when interest rates fall more than outweighs the effect on consumption from the people whose incomes have been reduced somewhat.

CHAIR: But you haven't modelled that?

Dr Ellis: Yes, we have. There is data that shows—firstly, there is modelling about the cash flow effect. I can't, off the top of my head, tell you all of the authors, but I know Gianni La Cava was one of them. It was Gianni La Cava and some co-authors; I would have to look it up to give you the other co-authors. So there is a recent paper on the cash flow effect. There is also some of our internal work; we look at the data, and there is more than one dataset that shows this. You can look at the HILDA dataset and some of the ABS household surveys that show you, for the people who get interest income, what fraction of income it is. There are certainly people for whom interest income is a significant fraction of their income, but in the older age group category the bulk of income comes from pensions, superannuation fund income, dividends and, increasingly, increased participation in the labour market. As the governor mentioned earlier, there has been a big increase, from a low base, in participation of older workers. The participation of men aged 65 and over has gone up 2½ percentage points just in the last two years. That's a big shift.

Dr Lowe: Perhaps I could offer one other perspective on it.

CHAIR: Yes, of course.

Dr Lowe: Certainly the modelling's important, and we try and track the data as best we can, but I have another perspective on this from the many people who write to me. Each day as I turn up to my office, there are some letters, and it's not uncommon for people to say to me they've worked hard all their lives, they've saved, they're frugal, they don't spend very much, they rely on interest income and they're having to cut back their spending. So I understand that it's a real issue for many people, and some of these letters go on to say that there are other people in the community who've borrowed a lot of money and they feel like they're being bailed out and the savers are having to pay for that. At the very human or individual level, I have a great deal of sympathy for the people who write to me. If I were in their situation, I would feel very similar to how they feel. So we understand that at an individual and human level. It's a very significant issue for many people, and we discuss this at the Reserve Bank board. On balance, though, our responsibility is to the national interest.

CHAIR: Of course.

Dr Lowe: And, as I said before, lower interest rates do support the overall economy, and if more people have jobs and income growth is stronger we'll all benefit, even though the distribution of those benefits is not even.

CHAIR: I don't want to be misinterpreted in what I'm asking, because I understand that there's modelling on the cashflow effect. The RBA has itself identified that there is a shift that is occurring within society. This is not a new shift; we've been aware of it. As I said, it's a paper I'm quoting from 2012. I understand when you look at individual households and their disposable income as a share of their overall income, but there hasn't been specific modelling to assess whether there's a need to review the efficacy of reducing interest rates on disposable income in light of that demographic shift; it's only on the basis of pre-existing data. Is that correct?

Dr Ellis: Yes. There has been a demographic shift and, all else equal, you do expect that that means that more of the household sector wants long interest-bearing assets and not so long equity, which is not what, for example, the typical super fund is composed of.

CHAIR: Yes.

Dr Ellis: So, with your asset allocation, as you get older it does tend to be longer fixed interest.

CHAIR: More defensive, yes.

Dr Ellis: That's true. Household deposits actually have not been growing at the same rate over the last five years as they did over the previous five years. I would have to look up the data; I don't think I've got those numbers with me. But, as part of our monthly numbers coming from the banks and other deposit takers that make up the money and credit statistics, we do get information on the split of that between household accounts and business accounts, and there hasn't been a continuing strong growth in deposits relative to income. So, all else equal, you would expect the demographic effects to have an influence, but all else is not equal. I'll come back to the example I gave earlier about participation. All else equal, given population ageing, you would expect the participation rate to have fallen by about half a percentage point over the last year. In fact, it has increased by more than a percentage point. So all else is not equal, and people are making decisions. As the governor said, we recognise that there are some people who are strongly motivated to hold interest-bearing assets. They don't want to take financial risk. They feel that deposits are a safe asset that they can put their savings in, and we appreciate that that's how some people want to allocate their assets, and therefore they're in a difficult situation, and we do appreciate that. Phil actually makes me write some of the responses, so I see these letters too. But it is important to recognise that all else is not equal, and so that demographic shift that my colleagues identified hasn't really influenced the portfolio of household wealth recently to the extent that you might have thought.

Dr Lowe: One final comment on the effectiveness of the cashflow channel: we haven't got any evidence that that has fundamentally shifted. It's changed at the margin as interest-earning assets have risen, but, as to the effectiveness of the cashflow channel, there's no evidence that that's become less.

CHAIR: But I think part of the point is: isn't all else equal, simply on the basis that one of the reasons why there may not have been an increase in the volume of savings and use of instruments like term deposits is the low return?

Dr Lowe: Yes.

CHAIR: I accept aspects of that point. A number of people raised questions and, at some points, criticism of the RBA, particularly for its decision, at its first board meeting after the election, to cut rates and then do it at the one immediately after that—and obviously, at the most recent meeting, it stabilised. To what extent do you believe that the election result had any influence on investment in the economy, which may have made it prudent to cut rates immediately after the election, before it had washed through, particularly in different policy scenarios?

Dr Lowe: The election had zero influence on our decisions.

CHAIR: I don't mean your decisions so much; I mean the decisions of investors. I won't say that they forced your hand, but people were looking at the different policy options available at the election, obviously, in their choice for a potential change of government; and that flowed through to investment decisions not being made, which made cutting rates an imprudent decision, rather than waiting to see through the wash-through.

Dr Lowe: I don't see any short-run impact on investment from the election—other than perhaps in residential property, where there was uncertainty about what the future tax arrangements would be. That probably had an effect at the margin. But, across the broad, on business investment, I don't think the election was a major factor—and it certainly didn't affect our interest rate decisions.

CHAIR: You have outlined consistently that we are in a lower interest rate environment and may continue there. In a 2017 conference paper, 'Is monetary policy less effective when interest rates are persistently low?' you say:

> This review suggests that both conceptually and empirically there is support for the notion that monetary transmission is less effective when interest rates are persistently low. Reduced effectiveness can arise for two main reasons: (i) headwinds that typically blow in the wake of balance sheet recessions when interest rates are low (e.g. debt overhang, an impaired banking system, high uncertainty, resource misallocation); and (ii) inherent nonlinearities linked to the level of interest rates (e.g. effect of low rates on banks' profits and credit supply, on consumption and saving behaviour—including through possible adverse confidence effects—and on resource misallocation).

In an environment in which the RBA's own research questions the efficacy of lowering rates in a low-rate environment, how does the RBA continue to justify lowering rates?

Dr Lowe: I wouldn't draw the conclusion that that paper says monetary policy is not very effective at low rates. It does outline some channels through which it may become less effective. There are two core channels. One is the exchange rate, and the evidence is that that is working. If we didn't have the level of interest rates that we have today—let's say they were one percentage point higher—I am confident that the exchange rate would be higher. That would be hurting our agricultural sector, our miners, our tourism sector, the education sector and the advanced manufacturing sector that we are building. So a higher exchange rate would be hurting many, many sectors across the economy. That part of the transmission channel still works as well as it has ever worked.

We talked previously about the cash flow channel. As I said, there is no evidence that that has become less effective. It is certainly true that, in the current environment—at least in my view—monetary policy is less effective than it used to be. Once upon a time, when we lowered interest rates people were very quick to run off to the bank to borrow more to spend. We saw that in the level of debt relative to people's income; it grew a lot. So that was part of the transmission through which monetary policy used to work. In today's environment people don't run off to the bank to borrow more when interest rates fall; they are more likely to pay back their mortgage more quickly. So that dynamic is different. The other dynamic that is different is that, as interest rates get lower and lower, it is harder for the banks to pass it through fully to the mortgage rates because their deposit rates start to bunch up around zero, and they can't reduce those anymore.

So there are those two aspects where it is not as effective as it previously was, but the exchange rate channel and the cash flow channel, which are two incredibly important channels, are as effective. So I wouldn't accept the proposition that lowering interest rates is no longer effective at stimulating the economy; it is just different than it used to be.

CHAIR: The question then is: what are the likely conditions that would emerge which would see the RBA consider increasing interest rates?

Dr Lowe: I look forward to that day because the conditions are that income growth has picked up, people are getting real increases in their wages, inflation's returning to target and we're at full employment or very close to full employment. So I look forward to that day.

CHAIR: Full employment being the new revised 4.5 per cent rate?

Dr Lowe: That would be my current best guess. As I think we talked about at this committee when we met in Sydney in February, there is a large ball of uncertainty around that estimate. But our current thinking is that we probably need to get down to an unemployment rate of 4½ per cent to have wage growth consistent with the inflation target. That's the world in which we'll be raising rates. We will not be considering raising rates until we're comfortable that inflation's going to be within the target range and we're close to full employment.

Dr LEIGH: Dr Lowe, you will have been in your position for three years next month. Would you agree that in the time you've been governor the Reserve Bank has pretty much comprehensively failed to meet its inflation target?

Dr Lowe: No, I wouldn't agree with the proposition that we've failed. We're facing some difficult challenges. Perhaps I can start off with the role of the inflation target, which I really see providing the north star for what we're doing. We're trying, over time, to get back to an inflation rate of two to three per cent. We want to deliver for the Australian community an average rate of inflation of two to three per cent. It's desirable and unavoidable that inflation will move around that medium-term range, and it's been below it for quite a while now. We're trying to get it back there, but we've faced difficult circumstances.

Dr LEIGH: But under your predecessor inflation averaged almost slap-bang in the middle of the target band, at 2½ per cent. Under your governorship, almost every time the Reserve Bank board has met it has been below the lower band, yet the decision was only made relatively recently to cut rates. In retrospect, does that look to you to be a mistake?

Dr Lowe: I think it's too early to tell whether we would have gotten better outcomes if we'd cut interest rates earlier. We have to let this whole cycle play out. Perhaps I can replay for you, briefly, our thinking through last year, when we did not cut interest rates.

Remember, in the first half of last year the economy was growing very quickly. I think in each of the first two quarters growth was close to one per cent, the unemployment rate was coming down, we got to a five per cent unemployment rate two years earlier than we thought, employment growth was running at 2½ to three per cent and the vacancy rate was the highest it had ever been. In the first half of last year, things looked like they were on track. Unemployment was coming down quickly, inflation had lifted, wage growth was picking up and we were growing at one per cent a quarter. In that environment, we thought it was reasonable that the economy would continue on that track, and we decided not to cut interest rates.

During the second half of the year, things did slow. Globally they slowed, consumption was weaker, the economy was hit by some supply disruptions in the resources sector and we had this big increase in labour supply. Progressively, as that data came in, we made a revision to our outlook and we adjusted interest rates in response to that. But through most of last year, things looked pretty good. They were clearly moving in the right direction. It's turned out since then that they've slowed a bit.

Dr LEIGH: You say things were looking pretty good, but you were still sitting below the bottom range of the target band. We still had unemployment, according to your new estimates of the NAIRU, sitting almost a full percentage point above where it could have been. Many have asked why a decision wasn't made to cut rates at that point.

Dr Lowe: During last year, the CPI in the first part of last year was at two per cent—it subsequently slowed—employment growth was very strong, as I said, and the unemployment rate was coming down more quickly than we'd thought. In that environment, we thought the most prudent thing was to let this improvement run its course. It was more than likely we would get back to two per cent inflation and the unemployment rate would come down further. As the evidence has come in that that wasn't the path we were on, we have adjusted policy. Whether we should have adjusted it earlier or not, I think only time will tell.

Dr LEIGH: But it did come at a fairly significant cost, didn't it? If I take your most recent general equilibrium model—the Rees, Smith and Hall model—that would suggest that an exogenous cut of 100 basis points would lead to inflation being about 0.2 percentage points higher, growth being about 0.6 percentage points higher and unemployment—if we take a conservative Okun's law estimate—being about 0.2 per cent lower. That's 20,000 Australians who were not in work as a result of that decision. That's a pretty significant cost to the economy, if indeed it was a mistake, is it not?

Dr Lowe: If it was a mistake, as I said, I think only time will tell. You have to remember that employment growth has actually been very strong. For the last three years, employment growth has averaged 2.5 per cent a year and the working age population is growing at 1.6 or 1.7 per cent. The economy has generated a huge number of extra jobs, and the employment-to-population ratio has never been higher in Australia than it is right now. One of the things that's happened, and that we're dealing with, is that the extra demand for labour has been there and the job creation has been there. A lot more people have joined the labour force. We did not predict that. As Luci has talked about, there has been a big increase in participation by older Australians and by workers. We did not predict that. The fact that labour supply has responded so quickly to increased labour demand has meant that the unemployment rate has stayed high, wage growth has stayed fairly low and inflation has stayed low. A lot of this—not all of it, but a lot of it—is coming down to the flexibility of labour supply, and we did not predict that.

Dr Debelle: If I think about it from a welfare point of view, welfare is primarily determined by employment. The fact is that more people have jobs than we had anticipated and that employment growth was faster than we forecasted a year ago—and it still is, actually. I suppose you can make the case that it could have been—as Dr Lowe noted, we were unable to predict that the supply response was going to be as strong as it was. That is true. You're able to see that now with the benefit of hindsight. That is something that is difficult to predict in advance. As it has turned out, if you want look at it from a welfare point of view, we do have more people in jobs than we had anticipated 12 months or even two years ago. As you map it through to the welfare costs, that is something to take account of. With the benefit of hindsight, can you make the case that things could have been even better? That's certainly plausible.

Dr LEIGH: But if you're concerned about the impact on wages, then unemployment is the key variable. Our unemployment rate has sat a percentage point higher than Britain, the United States, Germany or New Zealand for quite some time. Wouldn't you agree that unemployment could be lower, and would have been lower, had you chosen to cut as housing prices fell?

Dr Lowe: I certainly agree that the unemployment rate could be lower. The evidence is pretty clear that, because of labour supply flexibility, employment growth can be even stronger than we had thought. The evidence has accumulated in support of that proposition. As that evidence has accumulated, we have responded. If we'd known that labour supply was going to be as flexible as it has turned out to be, should we have cut interest rates earlier? Only time will tell there, and people have their different views on that. But we did not predict the flexibility of labour supply.

Let's say that the participation rate had stayed steady, which was our forecast two years ago, and we had the type of employment growth that we had, the unemployment rate today would be well below five per cent and wage growth would be stronger. The fact that labour supply has been so flexible means that it's hard to create a tight labour market and, therefore, wage growth doesn't pick up. We have discussed this at our board. It gives us the possibility for employment growth to be stronger than we previously thought. Lower interest rates are helping that. We have responded. We can debate whether we should have responded earlier or not, but, given the circumstances and the information we faced, we thought we made the right decision at the time.

Dr LEIGH: One of the arguments that were being made in favour of keeping rates on hold—or, as you said in November last year, the anticipation that the next movement would be upwards—was that there was some value in so-called leaning against the wind, maintaining higher rates as a means of ensuring greater financial stability. But Trent Saunders and Peter Tulip, in new research by the bank, suggest that that policy has greater costs than benefits—indeed, that the costs are three to eight times higher than the benefits. Do you accept that that new research suggests that the bank's focus on 'leaning against the wind' was misplaced?

Dr Lowe: I wouldn't describe our approach as 'leaning against the wind'. Through 2017 and the first half of 2018, as I described before, inflation was picking up. Employment was growing strongly. The unemployment rate was coming down. So things were moving quite well. The discussions we had around the board were about whether we should lower interest rates in that environment. We made the decision that it wasn't appropriate to do so. I accept that other people might have made different decisions. Part of the reason that we decided not to lower interest rates during that time, to get inflation up a bit more quickly, was the judgement that, if we did that, it would encourage more borrowing and higher housing prices, and, in an environment where there was already quite a lot of exuberance in the housing market, lower interest rates in an economy where employment growth was strong and inflation was gradually returning to the target were not in the country's long-term interests.

Dr LEIGH: Sorry to interrupt you; at what period are you talking about exuberance in the housing market, given that prices were falling?

Dr Lowe: The period '17, into early '18. By early '18, as I described before, employment was strong and the unemployment rate was coming down. But certainly through '17 and the early part of '18 we did not think it appropriate to encourage a faster return of inflation to target if that came with more borrowing and further upward pressure on asset prices. I accept that different people might make a different judgement about that, but that was our rationale.

Dr LEIGH: Including two of your own researchers, who seemed to suggest that the costs of that policy were three to eight times the benefits of the policy.

Dr Lowe: Yes.

Dr Debelle: We encourage diversity of opinion.

Dr Lowe: As you know, economists have lots of different views. That's one view. That's not my view. But we're prepared to put the paper out in the public domain. We encourage our staff to think about ideas from different perspectives. We put them in the public domain. I don't agree with everything that comes out, but I encourage people to put material out, even if it doesn't agree with the central view of the bank.

Dr Ellis: I think it's worth pointing out that, on the very same day that paper was released, another paper was released that showed quite important results—that, looking at microdata rather than macrodata, you can find evidence that high debt levels actually impinge on consumption in a way that hadn't previously been found. That's effectively the opposite conclusion. So, on the same day, we published two papers that had opposite policy conclusions.

Dr LEIGH: I'm surprised you're walking away from Trent Saunders and Peter Tulip's findings, partly because they fall in line with a lot of the international macroeconomic research—the work by Lars Svensson in a series of papers and the Canadian work by Alexander Ueberfeldt. There have been a succession of papers that have suggested that 'leaning against the wind' has larger costs than benefits, and you were doing so in an environment in which housing prices were falling rapidly.

Dr Lowe: I wouldn't accept that. In 2017 housing prices were not falling rapidly. The adjustment really started at the end of that year and in early 2018. My judgement, particularly through 2017, was that, with household income growth rising at maybe three or four per cent a year and debt rising at six or seven per cent a year, as it had been for quite some time, it was not in the country's long-term interest to get inflation up a bit more quickly if that came with continuing year after year of rapid credit growth—much more rapid than income growth—and that that carried certain longer term risks for the country. In the work that Peter Tulip and his colleagues have done, they say: 'That doesn't really matter that much. These risks coming from extra borrowing aren't really that material.' My judgement is different—that year after year of growth of debt much faster than people's income carries longer term risks, and ultimately we could be very sorry if they manifested. While the economy was doing well and inflation was broadly on the right track, it was prudent to allow that track to play out without encouraging yet further borrowing by the household sector. Once the borrowing by the household sector slowed and the track that we were on looked like it had changed we responded—this year. I accept others will make different judgements, and many of my staff do.

Dr LEIGH: What work has the Reserve Bank done on what unconventional monetary policy might look like as you head towards the zero lower bound?

Dr Lowe: It's possible that we end up at the zero lower bound. I think it's unlikely, but it is possible. We are prepared to do unconventional things if the circumstances warranted it.

Dr LEIGH: Could you detail them for me?

Dr Lowe: I hope we can avoid that. It's clearly prudent for us to be thinking about it, given the global forces that I talked about before. As part of our preparation or understanding of the issues, we've studied overseas experience in a great deal of detail. Perhaps I can quickly run through what's happened overseas and the lessons we've drawn from that. When we look overseas, we see some central banks have very low interest rates and some countries have negative interest rates. In Switzerland right now the interest rate is minus three-quarters of a per cent, in the euro area it's minus 40 basis points and in Japan it's minus 10. So some central banks have gone negative. That's one possibility. Another thing that central banks have done is give very explicit forward guidance that they're not going to move interest rates until some time has passed or until some certain conditions are met. So there is explicit forward guidance.

We've also seen some central banks support credit creation in their economies. There's a particular case in Europe where banks didn't want to lend. The European Central Bank has provided funding to the banks that is cheaper than the market rate, on the condition that they lend. We've seen that happen. We've seen some central banks expand their balance sheets very greatly by buying government securities in the effort to try and get the risk-free yield curve down. We've seen other central banks buy other assets, mortgage backed securities and corporate bonds. The Bank of Japan has bought equities. All are expanding their balance sheet. The other thing we've seen in just a couple of cases is foreign exchange intervention. Switzerland is the best example of that. Their currency was under strong upward pressure and they put a cap on it. This is the range of things that we've seen overseas.

I'm not thinking that any or all of those would be appropriate in Australia. There are some lessons, though, that we've drawn. The effectiveness of these measures depends upon the specific circumstances the country's in and the nature of its financial markets. There's not a one-size-fits-all here. Another lesson is that these measures have had clear success in dealing with dislocation and credit supply in the economy. I think Europe's the best example of that. They've also had success in lowering government bond yields, which is a risk-free rate, and therefore they've had success in lowering interest rates across the economy for private borrowers as well. A third message would be that a package of measures works best—rather than doing just one thing, doing a number of things that reinforce one another. A fourth lesson would be that clear and consistent communication is really important. We've seen some instances where the communication wasn't as clear and consistent as it could have been, and it's caused problems.

The final point that I'd raise is that a full evaluation of these measures can't yet be undertaken. You can point to some successes in lowering government yields and improving the dislocation in credit markets, but we're a long way from unwinding these measures, so a full evaluation can't yet be done. How we would apply those lessons to Australia would really depend upon the particular circumstances that we're in. I think the focus would be on trying to reduce the risk-free interest rate. We could reduce the cash rate down to a very low level, and it's possible, if the circumstances warrant it, that we could take action to lower the risk-free rates further out along the term spectrum. I think some of the other things wouldn't be appropriate, but we're certainly examining experience overseas and trying to work out how that would apply in Australia in specific circumstances. Again, it's unlikely. I want to repeat that. We're not doing this because we think it's likely; we're doing it because it's prudent in the global circumstances we face.

Dr LEIGH: Putting aside the zero lower bound, would a policy of explicit forward guidance be wise for Australia?

Dr Lowe: My perspective on this is that transparency is very important. Where's the borderline between transparency and forward guidance? I don't think it's that hard a boundary. I've tried to be very clear recently that we're expecting interest rates to stay low for a very long period of time. We haven't said 'until X date' or 'until these conditions are met', but we're trying to be transparent, so forward guidance is just another form of transparency.

Dr LEIGH: The Reserve Bank, unlike most other central banks around the world, doesn't publish transcripts of meetings, doesn't publish the voting record of members, doesn't hold regular press conferences after announcements and doesn't attribute views to board members in the minutes. Would you agree that the Reserve Bank of Australia's possibly one of the least transparent central banks in the world?

Dr Lowe: I would reject that strongly. We release minutes after every meeting. We release the results of a meeting straight afterwards, an hour and a half afterwards. It's true we don't have voting records; the decisions are taken by consensus as the board has decided that's the way it wants to operate. I give more public speeches than most central bank governors. I always take questions from the media at least once a month, sometimes twice a month, so I'm giving public speeches and taking questions from the media. I feel like the public understand what we're doing, why we're doing it and where we're coming from. We put a huge amount of material in the public domain. You can open up any newspaper in the country on any day and you'll find multiple stories about what we've said or what I've said, so I don't accept the idea that we're not transparent at all. We go to great efforts to have people understand what we're doing, why we're doing it and what trade-offs we're making.

Dr LEIGH: Thank you, Governor.

CHAIR: And to be fair, we get to ask you questions as well. And just for the Reserve Bank conference, at least you know some people are reading the research papers that you're publishing.

Dr Lowe: We do.

Mr LAMING: My first question is about an interesting word that you added to your written transcript here, Dr Lowe, in the second last paragraph on the first page. You said:

This means that we have a lot riding on these disputes—

those being international disputes around trade and technology—

being resolved.

You then added the word 'soon'. Could I put to you that the reverse is probably the case, that these are going to be here for years or decades? If we are to build in this uncertainty, assuming that it's not going to be resolved soon—India showed yesterday just how this can rapidly expand, if anything—how does your thinking change if we accept that we are a highly trade-dependent nation? Our trade is built mostly on large-scale commodities with very low labour ratios, I guess meaning that our trade can increase, but it won't necessarily change unemployment if we expand trade as much as a growth in our service economy, which has a direct effect on employment. Can't we just build this instability into our assumptions, and doesn't it then change your thinking?

Dr Lowe: Well, perhaps. I'm a bit more optimistic than that because the lesson from history is incredibly clear: no country has made itself wealthy and prosperous through protectionism. Building walls actually makes you worse off. We know that, in the end, building tariff walls—

Mr LAMING: Could I interrupt by saying it's not about being the fastest runner; it's just being faster than the other guy.

Dr Lowe: Yes. I'm hopeful that at some point that lesson from history will be sufficiently internalised so that it influences the outcomes. Maybe I'm inappropriately optimistic but I wouldn't give up hope yet, because if you're right, and these tensions don't go away, we're going to have a higher level of uncertainty for a long period of time. That's going to affect the investment climate. I talked before about how, when people don't want to invest and want to save, people get low interest rates, and that's what we're seeing, so that's problematic. If people don't want to invest, growth around the world will be lower and that will affect us here in Australia, including through wage growth and asset prices, so it's a very significant issue.

One potential offset, at least in the short run, is that the Chinese may decide to stimulate their domestic economy again. When they stimulate the domestic economy, they demand more resources from Australia and prices go up, and so we may get some benefit from that. And there may also be some opportunities in agriculture. China might decide to buy some agriculture products from us rather than the US, but they're very much short-run things.

If you're right and this goes on for years, investment certainly will stay for years; we'll see volatility in financial markets, capital accumulation will be slower and growth prospects for the world will be slower. So what does Australia do in those circumstances? I think we've got to make sure that our economy's incredibly flexible, which it is, and we've got to do every single thing we can do to support domestic productivity growth, because ultimately that's where improvements in our living standards are going to come from. If the global environment's not conducive to growth, then we can do things domestically that will make a difference. So I think, if you're right, that makes it even more important that we do the things to support growth domestically to make Australia a great place to invest, innovate, hire people and have businesses expand.

Mr LAMING: The lesson from the GFC was that high-tech manufacturing economies really took a hit, whereas the less elastic purchases like energy keep rolling on—where there are long-term contracts in commodities, for instance. So we want to stay in that space where, potentially, even with a global downturn, there is still reasonable consumption of the stuff we're offering the world. Isn't there a slight difference there—that countries that are high-tech manufacturers are again going to bear the brunt, just like they did in the GFC?

Dr Lowe: What we're seeing at the moment are the supply chains being disrupted, and that affects manufacturers, obviously. We're also seeing firms want to invest less, and a lot of international trade is in capital goods, so trading capital goods is softening. So you're right: those things are weak, and we may get some benefit in commodity prices, particularly if there is a stimulus in China. These are very much short-run things, and you couldn't say that these are actually good things. They're good in the short run, but they shouldn't give us very much solace.

Mr LAMING: We may just fare better than some of the other wealthy comparators—

Dr Lowe: We may fare better than others, but we'll all fare not so well.

Mr LAMING: True.

Dr Lowe: So we shouldn't take that much comfort that we're better than the person next door when the whole neighbourhood is not doing so well, which is the prospect we face.

Mr LAMING: We often compare ourselves with other rich G20 nations, but in reality, there's only just a handful of really truly trade-exposed wealthy countries. Do you find yourself looking at Canada as the best possible comparator, even though politically they're very different, when you look at the decisions the Reserve Bank's making?

Dr Lowe: I often feel that the Bank of Canada and the Reserve Bank of Australia have a very close affinity. Many of the issues we've faced over the past decade are very similar. We've both had a resources boom, we've both had housing booms and then adjustments, we've both had strong population growth and we've both got strong relationships with Asia. So, yes, I'd agree with the proposition that the Bank of Canada and the Reserve Bank of Australia are very similar, and it's great to be able to talk with the governor there periodically.

Mr LAMING: Just to finish, as government struggles with this propensity for those without work or underemployed to seek employment, there is quite a bit of political difference around this topic. There are 770,000 Newstart recipients who are getting income replacement, but only a small proportion—about 10 per cent of them—are actually taking up programs like PaTH, where an additional $200 a fortnight is paid to jobseekers if they seek out placement and work, and employers are telling us that the PaTH is not being picked up because they're not finding the right kinds of people. We really struggle with this propensity to seek employment. In a centralised, urban nation like Australia, with a mismatch between where its people are and where the job opportunities are, can you venture some possible measures that would increase the likelihood of people finding work, if the government has placed money on the table and is finding the PaTH program, if we take that as an example, is not a very effective measure?

Dr Lowe: I don't know enough about the specifics of these programs to offer any particular comments. Perhaps the one thing I can say is the importance of training and skills development by employers and through the education system, because I hear a lot of stories at the moment that firms are struggling to find workers with the necessary skills, and I think in the past decade there has been underinvestment in skills development by businesses, and maybe the VET system hasn't been working as well as it could have been as well. I think this needs to be a priority not just to give people jobs right now but to build the productive capacity for the future, and I think, as a nation, businesses and probably government haven't done enough there over the past decade. I don't know whether that addresses the specific issue you were raising but I think it's really important we do more there.

CHAIR: We'll go to Dr Aly now, and then we'll finish at 10.55 for a break.

Dr ALY: Thank you so much, Dr Lowe. In the fourth paragraph of your opening statement you talk about signs the economy is reaching a gentle turning point and the expectation that GDP growth outcomes will strengthen gradually, particularly over the next 12 months. You support this prediction via a number of developments. Among them are the lower interest rates and the recent tax cuts. I'd like to ask you to just expand on that a little bit. I'd like to ask specifically: how much of an impact have the recent tax cuts had, given that they haven't really yielded an increase in consumer spending? That's because they are being used to pay down household debt or are being saved for savings, as you mentioned earlier. Also, where is the outlook supported for GDP growth in the context of sluggish world growth, trade tensions and increased risk aversion?

Dr Lowe: On the tax offset payments that are being made now, we estimate that they will boost household disposable income by roughly 0.6 or 0.7 per cent of income, and that is a sizable boost. As I said, we are the government's banker; we can see the ATO paying back the refunds now more quickly than they normally do. People are putting their tax returns in more quickly, the ATO is processing quickly and the money is now hitting people's bank accounts. I think it's too early to see signs of that in spending, because this has only really been happening over recent weeks. We'll be looking very carefully this month, next month and the following month to see if we can see signs that people are actually spending this money.

Dr ALY: Sorry to interrupt, but do you expect it to go into spending?

Dr Lowe: Our estimate is, based on the payments during the GFC and international work, that people will spend around half of the money. They will use the other half to build up their savings or pay back their debt. We still get a reasonable kick to spending. It's not the full amount. If people use it to pay back their debt, that brings forward the day that they might spend. It doesn't help today, but maybe it helps tomorrow. If their balance sheet is in a better position, they might feel more comfortable to spend. It is too early to see the effects of that, but we're expecting it to be significant.

If I can just wind back to last year, one of the reasons that household income growth was so slow last year was that taxes paid by households rose by 10 per cent. Gross income by households was up 3.5 or four per cent, and tax paid was up 10 per cent. Last year, working Australians paid a lot more tax to the government and that restrained household income. I don't expect that to be repeated this year, and they are getting the tax refunds paid right now. I'm expecting that this will boost spending. I hope to see it in coming months.

Dr ALY: In the context of the sluggish world growth, trade tensions and increased risk aversion, I'm just really looking at what the factors are that cancel out any kind of outlook that indicates strengthening.

Dr Lowe: The depreciation of the currency helps. The Australian dollar now is the lowest it's been since the financial crisis. That helps education, tourism, manufacturing, agriculture and resources. The exchange rate, over 30 or 40 years, has actually been the great stabiliser of the Australian economy. I see that stabilisation role actually working out again now. That's important. The lower interest rates, which we talked about before, work through the cashflow channel. I think that still works.

On the resources sector in Western Australia, there's a hope that the gentle turning point is soon to be evident there, if it's not already evident. For seven years in a row, resource sector investment has been declining in Australia. That has been quite a drag on Australia and in particular on Western Australia. This year, we're expecting resource sector investment to increase a little and, given what we know about future projects, to increase a reasonable amount the following year. That is quite a turnaround. Something that has been quite a drag on the economy is now going to become a stimulus. We are seeing Australia's terms of trade increase again, mainly because of iron ore but for some other reasons as well, and that generates extra domestic income.

The stabilisation of the housing market, I think, is another important thing here. For some years, or for some time, the housing prices have been declining, and that has weighed on people's spending. You see it particularly in the purchase of cars and household goods. We are expecting housing turnover to pick up a bit and prices to rise a bit, and so people will spend a bit more and feel a bit happier.

So, together, there are enough things there to give us some confidence that the economy's actually going to pick up, and we've got to weigh that against the global developments, and it is hard to know how to balance those. But I think there are enough domestic things to say growth will strengthen.

Dr ALY: You mention also in your opening remarks options other than monetary policy, and you talk about fiscal support. In particular, you mention infrastructure spending and investment. What other forms of fiscal support are there? Specifically, I'd like to ask about population policy and wages policy—increasing wages.

Dr Lowe: Well, as I said, I would like to see stronger wage growth in the country, because it would help us get to our inflation target, as Dr Leigh talked about. So how do we get stronger wages growth in the country? At the Reserve Bank our strategy has been twofold. The first thing that I've been doing is talking publicly about the benefits of stronger wage growth and trying to lift wage expectations. For the central bank governor, it's controversial to say wage growth should be stronger, so that's got quite a lot of news, so I hope that helps lift wage expectations. And the second part of the strategy is to keep interest rates low for a long period of time to try and create a tight labour market, and a tight labour market will, in turn, turn into stronger wages growth. So they're the things that we can do.

I've also drawn attention in my prepared remarks to the wage caps in public sectors. Most public sectors have wage caps to 2½—some have 1½; I think in Western Australia it's probably even lower—and I can understand why governments are doing that, because it's important that we have budget discipline, and wages account for around 70 per cent of most state governments' budgets, so I can understand why the state governments want to do this. On the other hand, the wage caps in the public sector are cementing low wage norms across the country, because the norm is now two to 2½ per cent, and partly that's coming from the decisions that are taken by the state governments. So I'm hopeful that at some point the budget positions will improve sufficiently that state governments, or even the federal government, will be able to lift their wage caps.

Dr ALY: On population policy, particularly immigration being at 1.6 per cent for permanent immigration—but, of course, temporary immigration is much more amenable to market forces—are there any kinds of levers there in terms of creating physical support for growth?

Dr Lowe: Well, in principle, you can create extra demand in the economy through fiscal expansion, not just through population growth but by lower taxes or increased spending. I'm not saying that that should be done at the moment, but it is an option. If we find ourselves in the position where aggregate demand in the economy is very weak, we're not making progress on unemployment and interest rates are very, very low, I think the fiscal option would need to be on the table. One way of doing that, as I've noted, is increased spending on infrastructure, and what I find attractive about that is that it helps demand now but it creates future supply capacity in the economy. So we've got to do that carefully, because we don't want a repeat of what happened with LNG investment, where everything got done at once and the cost of doing it blew out. So we've got to sequence infrastructure investment carefully, but I still see potential to do more of that over time and help support demand growth in the economy, increase productive capacity and make people's lives better, and we can do it at very low interest rates.

So from my perspective it's, 'Tick, tick, tick, tick.' We've just got to find the right projects to do and to sequence them, and that would help demand growth in the economy. If the country as a whole comes to the conclusion that stronger demand growth is required to get unemployment down or get the economy growing at the pace we want, we face the question: how do you get stronger demand growth in Australia? And, as I said, monetary policy can play a role and is playing a role, but we do have other options as well, and at some point I'd like to see those other options explored, particularly if growth weakens from here. I don't think that's going to happen, but it's possible.

Dr ALY: How possible?

Dr Lowe: I don't want to put probabilities around it. It's inherently very difficult to know. If, as Mr Laming said, these global factors go on for a long period of time it's going to be a drain on us. If they're resolved in a way that restores confidence, with low interest rates around the world and the domestic fundamental support factors that I talked about, I think we could look forward to quite good growth. But it's inherently difficult.

Proceedings suspended from 10:50 to 11:06

CHAIR: We'll resume the hearing. Mrs Archer.

Mrs ARCHER: Dr Lowe, you talked in your opening statement—and you've talked a little bit more—about the unexpectedness of the labour supply flexibility issue. You talked about it being particularly in the area of women and older Australians. Could you expand on that a little bit more, with some of the reasons that you see for that and whether it's something that you factor into future calculations.

Dr Lowe: That's a very good question. As I said in response to Andrew's question before, the increase in labour force participation has taken us by surprise. I think there are a series of things going on. One is that older people's health is actually quite a lot better than it used to be, and so that's allowing people to stay in the workforce longer. That's a positive development. Another change we've seen is that hours of work are becoming more flexible. Part-time employment is much more available. Flexible working hours are much more common. That's allowing people to transition into retirement in a different way and stay in the labour force. Another thing that may be at work is that people are carrying debt into their 60s in a way that they once didn't. When the debt is still there, people feel like they've got to stay in the labour force longer. All these factors—the structural improvement in people's health, higher debt, more employment opportunities—are seeing participation rise. We're seeing the same factors affecting women's participation. Perhaps the slow growth in household incomes is a factor here as well. If one partner is working, and incomes are only rising at two per cent a year, when they used to rise at four, maybe the partner says, 'Well, I've got to work as well,' and, because part-time work is available and flexible hours are available, people are doing that. I think it's a good news story that a higher share of the adult population has a job today than ever before in Australian history.

Mrs ARCHER: You didn't expect that in terms of these calculations, but you anticipate you would factor that in going forward as something that may continue?

Dr Lowe: It's possible. The labour force participation of older Australians has picked up a lot, but it's not particularly high by international standards, and female participation in Australia is a bit higher than the average of the advanced economies but it's certainly not the highest, and there's quite a gap still between Australia and some countries. I think if the forces that I talked about before continue then it's reasonable to expect further structural increases in participation. It's a good news story but it does have this side effect. When there's strong demand for labour and a lot of people are getting jobs, the labour market doesn't tighten up that much, because there are more workers, which in one way is good but, in terms of generating wage pressures, it's an issue.

Mrs ARCHER: You said:

> We will all do better if Australia is viewed as a great place to expand, invest, innovate and employ people.

I would agree with that. You also said:

> A program of structural reform would help move us in this direction.

Could you expand on what you think such a program of structural reform might look like.

Dr Lowe: I'm always reticent to be giving the government advice, because the government doesn't give me advice and I don't want to give the government advice either. It's very much linked to the issue of productivity. What do we do to lift productivity growth in the country? If you go back over the last 30 years, in the early nineties to the mid-2000s productivity growth in Australia averaged 2¼ per cent a year. That was the basis of a big pick-up in our collective living standards. Since 2005 productivity growth has averaged about 1¼ per cent, so a full percentage point less. And just recently there's been very little labour productivity growth at all. I think this is a serious issue for us to confront.

There's no shortage of advice from people more qualified than I am. The government has commissioned endless reports, and there's a lot of other advice as well. I'd encourage anyone who is interested in this to read those reports, but I can perhaps summarise the main areas. Probably it won't surprise you that I'm starting off with infrastructure. The population has been growing rapidly. Up until quite recently we did not invest enough in transport and other infrastructure, and we're paying the cost of that now in terms of the productivity of the country—so, investing in quality infrastructure.

Another issue that people focus on is the way we tax land. I don't see any economist arguing that the current way that society taxes land is appropriate. The incentives the tax system established for innovation and entrepreneurship are something to focus on—so the tax system, the balance between consumption and income-generating taxes.

Competition policy is incredibly important because a lot of innovation comes when firms feel like they're competing with the person next door. Skills and education—we talked about those previously. The use of data by government to drive better delivery of services: the government is actually a very large employer. The Productivity Commission had a report *Shifting the Dial*, which talked about the possibility of a significant improvement in the delivery of health and education services provided by the government. There's no shortage of ideas across those various areas; the challenge is to work out which ideas to implement. I'm not going to provide the government advice on how to do that but these are the areas that I hope people are looking at.

Mrs ARCHER: Thank you. I don't have any other questions.

CHAIR: Thank you very much, Mrs Archer. I'll now go to Mr Bandt, if you're on the phone?

Mr BANDT: I am. Thanks, very much, Governor, and others. If 4½ per cent, give or take, is the appropriate number for what counts as full employment at the moment, what's the appropriate underemployment number?

Dr Lowe: I'm not sure I know the answer to that. The underemployment rate, if you count it in terms of the number of extra hours that people want to work, is around three per cent, and that's been fairly steady for a number of years now. I would hope that, if the labour market's sufficiently strong to get the unemployment rate down to 4½ per cent, underemployment would also decline. Because it's a fairly recent phenomenon, it's hard to know what the right number is there.

Mr BANDT: You mentioned it in your opening remarks, and I don't think many other people have raised it in the questions since. It seems to me that that is one of the key issues. Something is happening now that is different from before. Underemployment, especially amongst young people, has in fact gone up since the GFC, and, when you ask underemployed people how many more hours they want to work, 64 per cent said they'd like 10 hours or more, so it's not just wanting an extra hour or two. Amongst young people we now have what I would say is a near-crisis point in the country that's got worse since the GFC, where nearly one in three young people either haven't got a job or haven't got enough hours of work. Shouldn't we be paying more attention to underemployment than we currently are? Because, even if we get unemployment down, aren't we still going to have this massive underemployment crisis—and a growing crisis, as you say—that isn't being fixed?

Dr Lowe: As to whether we should be paying more attention to it, or not, I don't know the answer to that. But we should be paying attention to it, I agree. And I gave a speech in Adelaide about a month ago, where I talked a lot about underemployment. But it is important to keep this in perspective. Roughly a third of the labour force work part time. Back in the 1960s, I think only 10 per cent of the workforce worked part time. So there has been a very big increase in part-time work, which has allowed the rise in participation that I spoke about before.

The vast bulk of part-time workers are actually happy with the hours they work; it is only around 20 or 25 per cent of people working part time who say they want more hours than they have, and, on average, those people want two days extra. So there is a group of the population who are working part time who want more hours—and a stronger labour market, I agree with you, would help fix that. Beyond that, I'm not sure what the solution is, other than just making sure the labour market is strong and there is demand for labour, and then people get the hours they want to work.

Mr BANDT: Given that full employment is part of something that is your mandate and it is something that we have to consider as policymakers, and we have notional targets around that, should we also be considering a notional target around underemployment?

Dr Lowe: I would like to see it lower. I don't know what the right number is. I am confident that if the unemployment rate gets down to 4½ per cent we will see less underemployment. The two things move together. I think that if we can get the unemployment rate down to 4½ per cent we will see less underemployment as well.

Mr BANDT: On the question of public sector wages, we've got caps in place of around two per cent across the country—give or take. In some states it's a little bit higher. The federal level is two per cent. You've said those caps might be having a general depressing effect on wages generally. If public sector wages were increased by four per cent a year, the Parliamentary Budget Office estimates that that would have a gross cost of around $12 billion over four years—and you could perhaps offset that with some savings around consultancies and the like to bring it down to $9 billion. Is a four per cent increase in public sector wages out of the ballpark?

Dr Lowe: I'm not going to speak on behalf of the government. Four per cent does seem like a large number. In the medium term, I think wages in Australia should be increasing at three point something. The reason I say that is that we are trying to deliver an average rate of inflation of 2½ per cent. I'm hoping labour productivity growth is at least one per cent—and I'm hoping we can do better than that—but 2½ plus one equals 3½. I think that's a reasonable medium-term aspiration; I think we can do better, but I think we should be able to do that. So I would like to see the system return to wage growth starting with three. We have seen that with the minimum wage increase in the last three years. I think we had 3.3, 3.5 and three. They seem reasonable outcomes. Over time, I hope the whole system, including the public sector, could see wages rising at three point something.

Mr BANDT: If it were incorporated into government wages policy to allow for public sector wages growth at three point something, that would be of assistance?

Dr Lowe: We are in a situation now where wage norms have drifted down to two to 2½ per cent. At the Reserve Bank we talk a lot about inflation expectations lowering as a result of low inflation. But what is really important is the wage norms in the country. Most people are accepting wage increases of two to 2½ per cent. And the public sector wage norm I think is to some degree influencing private sector outcomes as well—because, after all, a third of the workforce work directly or indirectly for the public sector. So I think it is an issue but, on the other side of the ledger here, it is important that state governments manage their budgets prudently. I have spoken to a number of state treasurers. They say, 'We'd like to do more here but we've got a tough budget situation.' So there is a balancing act to be completed here. But I hope that, over time, that balance could shift in a way that would allow wage increases, right across the Australian community, of three point something.

Mr BANDT: One of the matters you mentioned before was around stimulating demand. Would lifting the rate of Newstart be helpful?

Dr Lowe: If you're asking: 'Would an increase in Newstart lift aggregate demand?' I think the answer to that is yes, because the payments are low and they haven't been increased in real terms for a number of years. I think if people who are getting Newstart got more money they would spend it, and so aggregate demand would rise. But this is another area where a balancing act needs to be achieved. It would cost the budget money, and the judgement for the government and the parliament is: if the government's going to spend more money, is this the best way of spending it?

Mr BANDT: Can I come back to a question about infrastructure spending that you referred to before. Given all of the factors that you outlined and given the specific situation that we find ourselves in at the moment, would it be better to have a small surplus and not borrow to fund infrastructure or to have a small deficit because of meeting the interest costs of borrowing for productive infrastructure?

Dr Lowe: I don't see the trade-off in those terms, because there are ways that you can fund infrastructure that don't require drawing on the recurrent budget. It's important that the recurrent budget is in good shape, because having a strong recurrent budget allows you options if things turn bad. We saw that in the financial crisis. Having run disciplined fiscal policy, the country had options that it wouldn't otherwise have had. It's important that we keep disciplined fiscal policy. We can do that and still support further asset accumulation, either by the public sector or the private sector, through infrastructure. There are ways that one can do that in a budgeting sense, and we see that the New South Wales government has done it a different way. Sometimes these projects can be financed off of the recurrent budget.

Mr BANDT: But it's not happening at the moment, and part of the reason is that there's a mindset that governments should not be investing public funds in these areas of what, perhaps, used to be called nation-building projects. It all suggests that, in many ways, neoliberalism is having its stagflation moment. Things are happening that aren't meant to be happening. The usual tools aren't working. Although interest rates aren't bringing down unemployment, extra money that people might get through tax cuts is just going to pay off debt. The government has still got its blinkers on and we're not having the spend on infrastructure that would get us out of this hole. We really need—don't we?—a rethink from government about the point of what government is for, otherwise these crises are going to continue.

Dr Lowe: I'll leave whether or not we need a rethink of what government's doing up to others. I wouldn't agree with the idea that we're not spending quite a lot on infrastructure. Spending has increased a lot over recent years, particularly in New South Wales and Victoria. The federal government has a plan to spend $100 billion over the next 10 years on supporting various infrastructure projects, and the state governments are spending a lot more. We're actually spending a lot on infrastructure at the moment. The debate is: how do we keep that high level of spending and what are the opportunities, perhaps, to do a bit more, particularly if we need more aggregate demand growth? I know that the treasurers are thinking about that at both the state and federal levels.

Mr BANDT: At the last hearing I had some discussion with Dr Debelle and Dr Ellis about climate change. I understand that you're in the process of updating the kind of modelling that could be done within the Reserve Bank and considering climate change impacts, the IPCC's report, the need to phase out thermal coal and so on. Is there anything further that you've done on the climate change front and the modelling on the economic impact, since your last appearance before this committee, that you can update us on?

Dr Lowe: I'll hand over to Guy.

Dr Debelle: Absolutely. As I think you know, we have for a while now been members of this global central banking group, the NGFS. We're working actively there. One of the things we are working directly on, along with colleagues at the Bank of England and a few other central banks—this is not directly related to what you just said but is where we're devoting our resources at the moment—is thinking about various stress scenarios and stress testing that we think both investors and financial institutions should wish to consider in their reporting on this, which most of them are now doing. That's one of the areas we've been devoting some resources or some of our thinking to over the last little while. You may have seen that the Bank of England last month, I think, put out some scenarios for the insurance industry in the UK to consider. We made some contribution to that. I hope that later this year, in a couple of months time, there'll be some work put out by the NGFS, which we are making a reasonable contribution to, which expands on that. That's one of the areas we've been focusing on and working on with fellow regulators in Australia—APRA and ASIC—and how that might be most usefully applied to the Australian financial system. That's certainly one of the areas where we've been spending a fair bit of time in this space since we last met.

Mr BANDT: Are you doing any work on the impact on Australian exports—for example, agriculture and so on—if droughts get worse, as predicted by IPCC reports, considering particularly Australia's unique exposure given our industry profile?

Dr Debelle: We're obviously spending a fair bit of time looking at the impact of the drought on the economy right now and the fact that it's still going on and the impact in some parts of the country, at least—although I suspect the part of the country we're in right now is welcoming the rain that it's getting, which is the first in a while. That's one thing we're considering. We have talked to a number of groups, including the National Farmers' Federation recently, about this and some of the thinking that they have. An interesting thing about Australian agriculture is that one area where we have seen a lot of productivity growth and technological progress over the last couple of hundred years really is in adapting to the changing climate. I think our agricultural sector is one of the more advanced in its adaptation to that. One of the interesting challenges around climate, as well as the direct impact, is how people respond as the situation changes. Our agricultural sector has proven to be one of the more flexible ones. So that is something that we think about. It's both: what is the direct impact but also what is the likely response and how are we likely to adjust? We can look back at how that's changed, and it has changed quite dramatically over the last 50 years as our agricultural sector has adjusted to the change which has already occurred, and we can use that as some guide as to how it might adjust in the future.

Mr BANDT: So it's all going to be okay?

Dr Debelle: No, that's not what I said—no, not at all. The outlook isn't fantastic on this front, but you've also got to think about how things adapt to that. That's the challenge for us: you look at the direct impact but then you've also got to think about how the different parts of the economy are going to respond as the situation changes. That is something we are still devoting time and effort to thinking about.

CHAIR: I want to clarify a comment by Mr Bandt. He said that we are in a stagflation environment. Would that be the view of the Reserve Bank?

Mr BANDT: That's not what I said, Chair. I said that neoliberalism is having its stagflation moment, where things are happening, just as Keynesianism did; we're reaching a crunch point now—that was my point. I didn't say we're in a stagflation environment.

CHAIR: Let me ask for your reflection on that.

Dr Lowe: Stagflation is what I learnt about when I first started studying economics in high school in Wagga, not that far from here—and that was high unemployment and high inflation. Today we have exactly the opposite. I gave a speech a couple of weeks ago and said that the standard exam question when I was doing the HSC was: 'Why does the country have high inflation and high unemployment, and what should government do about it?' The kids who are doing their HSC now—and I have a daughter who's doing the HSC, but unfortunately she's not studying economics—are getting asked a very different question: 'Why is inflation so low, why is unemployment so low and what should public policy do about it?'

Mr BANDT: That's right. The exam question at the moment surely is, 'Why is inflation so low, interest rates so low and wages growth so low, while underemployment is growing and not enough is being spent on infrastructure?' That would be the exam question now, wouldn't it?

Dr Lowe: That would be a very good question, and I'd look forward to seeing the answers.

Ms PAYNE: Thank you so much for taking our questions today. I'd particularly like to focus on the extended period of unusually slow growth in household incomes weighing on household spending that you mentioned in your opening statement. Obviously wages is a very key part of that. Particularly in the current environment, with the high level of underemployment and without stronger upward pressure on wage growth, what levers are available to boost employment and wage growth?

Dr Lowe: As we talked about before, employment growth has actually been strong—2½ per cent on average over the last three years, which, given the growth of the population, is very strong—so the issue isn't a lack of employment growth. As we said, the supply side has been very responsive.

Going forward, how do we ensure that employment growth remains strong? At least conceptually, the options are fairly clear. The first set of options is monetary policy stimulus, which is what we're doing, and, if needed, we're prepared to do more. As we've discussed, our second set of options are fiscal options. And the third set of options, which are my preferred ones, are creating an environment where businesses want to expand and hire people. That's the menu, and it's up to society, through the parliament, to choose from that menu.

Ms PAYNE: Sorry, I probably should have phrased it differently with regard to employment growth. We have a level of unemployment that is higher than it needs to be to stimulate wage growth. On the fiscal side, what more could the government be doing to address that unemployment, particularly underemployment.

Dr Lowe: I don't want to provide the government with advice on what it could be doing, but at least conceptually, if aggregate demand growth is not strong enough, fiscal stimulus could be one way of overcoming that. I'm not calling for the government necessarily to do that, but just conceptually that's what you could do. You could have monetary stimulus, fiscal stimulus, infrastructure spending and—the final one; the best one—create an environment, through structural policies, where firms want to expand. We talked briefly about the range of options there. Beyond that, I'm not sure I've got much more to say.

Ms PAYNE: You've mentioned caps on public sector wages. Do you feel that's an important part of slowing wage growth and household spending? Is that a lag on household spending more generally?

Dr Lowe: It's part of the story. The public sector, directly and indirectly, employs roughly one-third of the labour force, and they're saying wage increases across the public sector may be averaging two per cent. That has as indirect effect on the private sector, because there's competition for workers and it reinforces the wage norm in the economy at two-point something. I know that treasuries have to balance the considerations about the benefit they'd get from stronger aggregate wage growth against needing to deliver responsible, balanced budgets. Again, that's a trade-off that our society is making through its governments, and the trade-off that they're making is to entrench low wage norms in our country. Whether it's the right trade-off, I'm not going to comment on that.

Ms PAYNE: No; of course.

Dr Lowe: But if they made a different trade-off and wages in the public sector were rising at three per cent, then over time I think we'd see stronger aggregate demand growth in the economy. I don't think it would have much of a negative effect on employment; in fact, arguably it could be positive.

Ms PAYNE: I'll come to infrastructure spending in a moment; but, aside from infrastructure, what would you describe as some examples of a successful fiscal stimulus package?

Dr Lowe: If you go back to the global financial crisis, the fact that Australia ran disciplined fiscal policy for many years allowed us to have one of the biggest fiscal stimuluses around the world. I know there's debate, and rightfully so, about the size of the stimulus and the particular design of the package, and there are issues there, but at the big-picture level, that fiscal stimulus did help the economy get through what was a very, very difficult period. Remember that back in late 2008 people were predicting the unemployment rate going to seven or even eight per cent. For various reasons, Australia got through the global financial crisis with the unemployment rate going close to six per cent and growth returning pretty soon afterwards. The fiscal stimulus was part of the answer there. We were only able to do that because of the good history we had. We saw some countries which had run poor fiscal policy in the past actually have to tighten fiscal policy in the middle of the global financial crisis. We didn't. So it can work.

Ms PAYNE: Obviously, part of that package was 'go households' and target them directly. Could you comment on the role of the social security system in stimulating household spending in the current context?

Dr Lowe: I'm not sure what in particular you have in mind. We've talked about the tax offset payments that are now occurring. I think that is stimulating spending. Beyond that, I don't think there are other measures in the social security system that are having an effect at the moment. I'm not sure of other changes that are being proposed. I mean, we've discussed the possibility of Newstart, and again that's a trade-off. I think increased spending there would see greater spending in the economy, but it's a balance. A government has to decide where best to spend its scarce resources.

Ms PAYNE: Absolutely. Looking at the tax cuts, in terms of stimulating household spending, do you think an increase to Newstart allowance or tax relief to people on higher incomes is more effective?

Dr Lowe: In the short run I think you get more stimulus from giving money to people who have a high propensity to spend that money, and that's obviously lower-income people. In the short run I think the answer to that is pretty clear. In the longer run it's more complicated because we've got to think about the incentives for work and innovation and reward. So it may be that, in the longer run, having lower tax rates on people who earn high income, either through entrepreneurship or other reasons, actually stimulates more growth in the economy so everyone can be better off. In the long run, there's not a simple answer. In the short run, though, the answer's simple.

Ms PAYNE: Given the situation we're in at the moment, where we're coming to record-low interest rates and no pressure on wages, do you think we should be focusing on those shorter-term objectives at the moment?

Dr Lowe: No, because the central scenario for the Australian economy still remains quite reasonable. We're expecting growth to return to trend, the government's projecting a budget surplus and inflation is going to gradually rise back to two per cent. In the broad scheme of things, in our history, having inflation close to two, growth on trend and unemployment around five is not so bad. If that's how things work out, maybe we could do a bit better, but there's not an immediate call to do things to make things better. It's more an issue of the long term.

What I'm increasingly concerned about is the low productivity growth, and the prospects for that to continue, because if productivity growth is low, it means real wage growth is low, the budget is going to come under greater pressure, the value of people's assets won't rise at the rate they expect and people's incomes won't rise. For me, that's the much more important challenge for us to address than trying to manipulate aggregate demand over the next little while. If the situation turns bad and the global economy has a downturn, we may need to think about measures to stimulate aggregate demand because we're falling short of the central scenario. That's a debate we might have to have. I hope we don't have to have it, but we might have to have it. The much more important issue is: how do we keep generating growth in our real wages, our real incomes and employment over the next 10 or 20 years?

Ms PAYNE: On that productivity, what policy levers do you think are available to boost productivity?

Dr Lowe: I ran through my list before. I could read it out again, but it's not my core area of competence; the governments around the country have large public services to advise them on that. But I read out my list. I've read many of these reports and I think a lot of these ideas would be actually quite good. But they would all be politically contestable, and it's really up to you, the parliament, to work out how to solve those political contests. There's no shortage of good ideas out there—things that I think would make a material difference to the growth prospects of the country. It's up to the political class to work out which of those it can support. I'm not going to give you advice on how to do that, but I know there are things that could be done, and I think that's actually a much more important priority than arguing over the next six months or 12 months. Make sure that our kids have living standards materially better than ours. If productivity growth doesn't lift, then they're going to struggle to have materially better living standards than ours. I think that's a much more important issue for us to grapple with.

Ms PAYNE: If I could, I want to come back to the importance of infrastructure investment that you've mentioned. What types of actions, specifically, could the government be taking to support that growth further?

Dr Lowe: Broadly speaking, at least in the transport area, there are two types of infrastructure investment going on. There's the big megaprojects. We see those in Sydney and, to some extent, in Melbourne. I think in the large capital cities at the moment there's probably limited scope to do another big megaproject. People tell me there are capacity constraints and the prices are rising, so we do have to be careful there. It's really a job for the state governments to plan to make sure that there's a strong pipeline of projects so that, as one winds down, they can do another one and, wherever they can, perhaps do a bit more, particularly if the economy were to weaken.

The second type of infrastructure project is much smaller in scope, and there I think there is scope to do more across the country, particularly in regional areas—maintenance of rail, road and bridges and some expansion of regional infrastructure—because people tell us at the regional level there is still spare capacity. There may not be the capacity for the big megaprojects in Sydney and Melbourne, but right across the country there is the capacity to do more infrastructure spending that would make people's lives better and improve the quality of people's existence, so I encourage governments to look at the possibility of a series of smaller projects. They're not a big as building a metro in Sydney, but they can be more widely dispersed across the country, and that can help us all.

Ms PAYNE: What do you think would be the ideal time period to bring forward those projects, in terms of stimulus?

Dr Lowe: I don't know the answer to that. It really depends what happens. If we proceed along the central scenario, I would describe that as kind of okay. Do we have an aspiration to be better than okay? I'll leave that up to you. If things turn out not to be so okay, then these issues would become pressing. If the global economy were to weaken, if these trade tensions were to get worse and if the Australian economy were to underperform our central scenario, then I think these would be serious issues, because then we wouldn't be doing okay, and in that situation we should be looking to all arms of public policy to help. But, in the central scenario, things are broadly okay, aren't they? We're looking at five per cent unemployment, two per cent inflation, growth around trend and a budget balance. Now, we might like to be better in a number of those dimensions, but broadly that's okay, and if the society can make a choice to be better than okay, it—

Ms PAYNE: The wage situation's not really okay though, is it? That's something we really need to address.

Dr Lowe: Yes. Income growth is still weak. I think it'll pick up a bit, but it's still weak. How do we turn back and have wage growth with a '3' in front of it? I think it's stronger demand. We've been through the options there, and it's really an issue for the governments across the country and whether they want to do that or whether they can live with growth being kind of okay and wage growth being as it is.

Ms PAYNE: What do you think will happen if they don't? If fiscal policy isn't working in the same direction as monetary policy is at the moment, what are the implications of that?

Dr Lowe: I think things will be okay. But I hope that we can lift our sights higher than things being okay, and I think, as a country, we can do that. But it does require some of these structural issues that I ran through before to be addressed, and that does require the political classes to come together to agree on and support some structural changes. That's completely out of the area of the central bank. It's really in your area. Are we happy for things to be okay or do we aspire for something better? I hope, as an Australian, we can do the latter, but, if we don't, then I think things will be okay.

Ms PAYNE: I hope we can aim to be better than okay too. Could you comment on the quantum of infrastructure investment that you think is required to have the desired impact?

Dr Lowe: We have a very high level at the moment. I think it is important that we sustain that level. That requires the sequencing of projects, as I talked about before. At the margins, I think there are some opportunities in some areas to increase it. I talked, particularly, about regional Australia and smaller scale projects, where you are not going to put pressure on capacity constraints. If things turn down in the economy, I think we should be more ambitious and look for further opportunities. Let's hope we don't have to confront that situation, but it's one of the things on the menu. It's really going to be up to the governments, particularly the state governments around the country, to select whether they want that item from the menu or they want other ones. We all face trade-offs.

Ms PAYNE: Thank you.

Mr LAMING: I have two unrelated questions. Maybe we could give you a rest, Dr Lowe, and ask Guy a question. The first question is just about understanding better what is probably an old chestnut that has been discussed prior to me being on the committee. It is an issue that is often raised by property investors, and it is basically about government's preference for residential property investment. It's a $2.7 trillion industry. A lot of people who are in the market have some gripe about paying more for investment home loans than residential home loans and also about being made to pay principal and interest instead of just interest only. On those two fronts, does the RBA have a view? Now that rates are getting so much lower, these differentials are relatively large compared to the actual rate, which they may not have been when rates were much higher. Are either of these two issues presenting any problems for the nation if investors feel that they have to pay more for a property loan than a homeowner? Secondly, are they being forced, in some cases, to pay P&I rather than interest-only through this period?

Dr Debelle: This is actually Michele's corporate area of competency, but I will make two comments. On the principal-and-interest and interest-only loans, that was a constraint on the flow. It wasn't a ban. It was just a constraint on the flow, which was predicated—with the very high share of interest-only loans—on the concept that having a large chunk of the loans in the country not requiring any repayment of principal didn't sound like a great situation for the medium-term financial health of the country and probably put us at a point that was risky. But it was a constraint on the flow, not on the stock. In terms of the spread between owner occupiers and investors, in the end—and it is true of all interest rates—it was an assessment around wanting interest rates to reflect the relative riskiness of the proposition. Those who lend, I would hope, would have the capacity to be able to do that and set the rate appropriately. But I will give Michele the opportunity to say something.

Ms Bullock: I will only add a couple of other points. Guy is right in the sense that the distinction or differentiation between the home loan rates came in when APRA put some constraints, firstly, on growth in investor loans and then, secondly, on interest-only loans. At the time, around 60 per cent of investor loans—the flow, as Guy said—were interest only. There's a reason for that. What investors were doing was utilising certain advantages in the tax system to basically bet on the capital gain. Despite those differential rates coming into play, 40 per cent of investor loans still are interest only. They are making a judgement that it is still worth their while to take out those sorts of loans.

The issue of interest-only loans for owner-occupiers I think is a slightly different issue because, in principle at least, you'd hope that an owner-occupier might be wanting to get increasing equity in their home over time, and that reduces the riskiness of that loan to them because it means they are getting more equity in their home and, if prices decline a bit, they are not going to find themselves under water. So I think the differential interest rate is a sensible thing that the banks have done. They introduced it for a specific purpose. Sure, there are fewer investor loans across the board generally, but that's more related to the way the house prices have been going. I think interest-only loans are still available for investors, and a large portion of them are still taking them out.

Mr LAMING: So there is still a very good case for the size of that differential remaining, as opposed to reducing the differential, given the fact that all rates are now lower than they were when this decision was made?

Ms Bullock: That's ultimately a question for the banks themselves. The banks are the ones that set the interest rates. Interest-only loans are slightly more risky, so you would expect a differential. But the differential that the banks charge is ultimately a question for them, and competition between banks to lend to good risks will ultimately govern how big that differential can be.

Dr Debelle: I would add that that differential has indeed, for exactly the reasons Michele just outlined, been coming down over the last couple of months. We've seen a number of the investor loans—by some of the banks, not all—being reduced by more than the owner-occupier rates recently.

Mr LAMING: I want to ask you about the decision by different jurisdictions to invest in infrastructure. All states are doing it differently, and the three eastern seaboard states are a useful case in point. We look to Infrastructure Australia to do cost-benefit analyses of applications for government funded infrastructure, but it worries me that increasingly what I'm seeing in Queensland is a reduced pool of infrastructure constructors who, among a very small group, take on very large projects. We have a history of getting the economics of these projects wrong. For example, at Queen's Wharf in Queensland, we are seeing incredibly inflated wages agreed on site for a relatively small proportion of employees. They talk about the stop/go person earning in excess of $160,000 a year and the entry level cabinet-maker earning $250,000 a year. That is an increase in the wage, but is it in the public interest to see wages increased in that way?

My broader question is: from your elevated position, do you start to have concerns about the way in which jurisdictions of all types are investing in social infrastructure, as opposed to economic infrastructure, which was the debate during the GFC? Even now, we are calling a lot of stuff economic infrastructure. It is the difference between investing in congestion in major cities, as we approach peak vehicle, and investment more directly in constructing industrial infrastructure that is often well away from the major cities. Is there good and bad infrastructure, as far as you see it?

Dr Lowe: There is certainly good and bad infrastructure, and it is possible to waste a lot of money in this area. But it is also possible to build great assets that the country needs for its future growth. The task that the political class has is to balance those things and make sure that the governance around project selection, cost management and risk sharing between the public and private sector are all in the public interest. In front of this committee, for many years, I have been extolling the virtues of improving governance around infrastructure selection, construction and pricing. I think it is necessary for the public to have support in the process as well. If the public see money not being spent wisely, they lose support for governments building assets, which, in the end, will harm us all.

I don't know the specifics of the cases you are talking about, but governance is really important. People think of infrastructure as megaprojects—the subway in Sydney or the Cross River Rail in Brisbane. These are important for our major cities, but there are a lot of infrastructure projects right across the country, in regional Australia, that also need attention. We can do those, if you have a decent governance system in place, and improve people's lives and help regional Australia. We have got to be careful that we don't say, 'Governments do this badly, so we're not going to try.' We're better off saying, 'How can governments do this really well and business, the community and government support good processes so that the public can have confidence that when governments are spending our money they're doing it wisely?' We'll all be better off if we can do that.

Dr LEIGH: Governor, just to take you back to one of your comments about public sector wage caps, the New South Wales government is apparently considering dropping its wage cap from 2.5 to two per cent. If it did that, what impact would that have on the New South Wales economy?

Dr Lowe: My understanding is they're not going to do that.

Dr LEIGH: In the event that your understanding was wrong, what impact would it have on the economy?

Dr Lowe: Well, it would be a move, in my view, in the wrong direction, but that's a matter for the government. It's got lots of things to balance. But I started talking out publicly about the benefits of stronger wage growth a couple of years ago when I was in a function at ANU because I was concerned then that the wage norm was maybe going to slip below two down to one point something and, if that became the wage norm in the country, there's no way that we're going to achieve 2½ per cent average inflation. So I think with a wage norm of two to 2½, where we are now, I wouldn't like to see that lower, and I don't think decisions by the New South Wales government are going to move in that direction.

Dr LEIGH: We spoke before about transparency, and I note Kevin Warsh's 2014 study of transparency across 10 central banks, which placed the Reserve Bank second lowest on the list. I ran you through a number of transparency measures earlier, including publishing transcripts of meetings, voting records, regular press conferences after decisions and the attribution of views in the minutes. Am I to understand that the Reserve Bank has no intention of implementing any of those transparency changes, despite the fact that many of your counterpart central banks do so?

Dr Lowe: On transcripts, I don't think most central banks publish transcripts. The Fed does, with kind of a long delay, but that's not the standard practice.

Dr LEIGH: And the Bank of England and the Bank of Japan.

Dr Lowe: I've never seen these transcripts.

Dr Debelle: No, the Bank of England don't. They publish attributed views; that's correct. I'm pretty sure that's right.

Dr Lowe: A transcript really is kind of what we see in *Hansard* here, with everyone's views being recorded in detail. The Fed, I think, does that with a very long delay, doesn't it?

Dr Debelle: It's five years.

Dr Lowe: Five years. So we're not considering that. The minutes of the meeting are pretty comprehensive. As I read the minutes, I can see every graph that's been presented during the board presentation. So the minutes are very comprehensive.

On press conferences, I've thought about that—a press conference after every meeting. The Reserve Bank of Australia board meets more frequently than the central bank boards in most other countries. The standard is now eight meetings a year or sometimes fewer than that. We meet 11 times a year. I think meeting frequently is good. So, if I did press conferences, that would be 11 press conferences a year, plus all the other regular speeches—one or two a month—and I'm a bit worried that the community would end up hearing too much from the central bank. I feel that at the moment the community hears a lot from me and the central bank, and I'm not convinced that adding to the number of public appearances would be in the country's interest. I hope people can focus on things other than monetary policy.

The other one you mentioned was attribution of votes, and we have long taken a view that these decisions should be taken by consensus, and the board supports that. I support that. And, through the discussions at the board, we always reach a very high level of consensus, so I don't see anything to be gained from attributing individual views. And the board has also agreed that the governor is the spokesperson on monetary policy to try and make sure the communication lines are as clear as they can be.

Dr Debelle: I suppose I would also note that the composition of our board is different—and that's a function of you, the parliament—in a way, from, I think, all of those other central banks you meet, and I think that is a consideration you at least have to think about in heading down that route.

Dr LEIGH: Indeed, and I was going to go directly to that issue. We've discussed a range of macroeconomic concepts: Okun's law, the Tinbergen rule, the Taylor rule and dynamic stochastic general equilibrium models. What share of your external board members would have a deep understanding of those concepts?

Dr Debelle: I think it's a reasonable question as to whether some of those concepts are useful for anyone to have a deep understanding! I think there's an issue of what perspective you want a central bank policy board to bring to these discussions, right? And I think that's an interesting question to think about. I'm not saying there's a right or a wrong answer, but there is possibly more than one answer to that question. The Parliament of Australia—and I'd emphasise it's the Parliament of Australia, not our choice—has chosen to have a board which is made up of a different constellation of people to make this decision around monetary policy than other countries have chosen to do.

Another thing to bear in mind in thinking about that is that, if you look at the composition of the US Fed, up until about five years ago there was a big shift towards having, for want of a better descriptor, academic economists constitute the vast majority of membership of the FOMC. If you look at that constitution today, it's actually shifted away from that, so there are fewer on the board. It's an interesting question to think about as to what gives you the best decision-making. There's not an obvious answer to that question. Do you want a diverse set of views rather than a set of views purely from a particular perspective as to what gives you the best outcome? It's really not at all obvious to me what the answer to that question is.

Dr LEIGH: Those arguments are well taken, Dr Debelle, but you cunningly slipped past the actual answer to the question.

Dr Debelle: Sorry, what was the question?

Dr LEIGH: How many of your external members would have a familiarity with concepts such as Okun's law, the Taylor rule, DSGE models—

Dr Debelle: We provide information to them on a monthly basis. The information is of the sort that I think you, as a trained economist, would expect to be presented to a board making those sorts of decisions.

Dr LEIGH: I still feel an answer is eluding us.

Dr Debelle: No. What I am saying is that they are then able to process that information. I don't think it requires a PhD economist to understand all of the concepts that you outlined. They are people who are used to dealing with complicated issues and dealing with risk management and, therefore, are able to get their heads around, and do spend the time making sure they do get their heads around those concepts and ask questions if they don't understand the stuff that's put in front of them.

CHAIR: If the suggestion, Deputy Chair, is that there should be a skills matrix against particular theories, I'm sure they can take it on notice.

Dr Lowe: I can tell you that 100 per cent understand the concept of NAIRU. We've had extensive discussions about that, about capacity constraints and potential output—I can tell you that 100 per cent understand that. They 100 per cent understand the Phillips curve and the link between inflation and unemployment.

Dr Debelle: Probably greater than the economics profession.

Dr Lowe: They may not fully understand how to interpret econometric equations and stochastic equilibrium models, but there is a high level of understanding. I'd pick up on one other point that Guy made, which I think is really important. From my perspective, much of the time we're dealing with decision-making under uncertainty. The world is inherently uncertain, as we've talked about today, and the job that we have is more than just a technical job; it's how to make the best decisions under uncertainty. What I've noticed over time is that people from business and other backgrounds typically have very good skills at making decisions under uncertainty. The frame of reference they bring is sometimes different from the technical perspective, and a board, which is what the Reserve Bank board has, which marries those things together works very effectively. I do not have any concerns at all about the competency of my board. I think they bring great perspective and they're very good at making decisions under uncertainty and considering trade-offs, because that's what we have to do.

Dr LEIGH: Over recent years a number of other central banks have chosen noncitizens to head the bank: Stan Fischer to head the Bank of Israel; Mark Carney to head the Bank of England. Increasingly, it looks as though there's more like a global labour market for central bankers. Supposing that a future Australian government were to go down that path, what changes would that necessitate within the way in which the Reserve Bank is internally managed?

Dr Lowe: None, I don't think. It would be a matter for the government whether they wanted to appoint the next governor as a non-Australian. I'm sure if they did that he or she would manage the bank as he or she saw fit. I can't speculate on what changes the next governor might make, and I don't think the nationality is particularly important from that perspective.

Dr LEIGH: So the prospect of an external appointment wouldn't change in any way the way in which you manage the institution?

Dr Lowe: It very much depends upon the individual, doesn't it? You can imagine some external people wanting to do something very differently and others kind of continuing. I don't think the nationality of the person is important in terms of what changes they might make. It's entirely a matter for the government whom they appoint as the governor and the board members of the Reserve Bank. I don't want to speculate on what might or might not happen in the future.

Dr LEIGH: Finally, New Zealand unexpectedly cut rates by half a percentage point this week. Did you get a heads-up about the decision? What does it mean for your thinking now about monetary policy in Australia?

Dr Lowe: We did not get a heads-up on that decision. Central banks, most of the time, do not give a heads-up to other central banks. This information is incredibly tightly held. It's very market sensitive. So we don't whisper in advance to one another what we're going to do. Does it have any immediate implications for us? No. Our exchange rate came down in response to the cut in New Zealand, but they are responding to the same forces that we're responding to. At the global level, the elevated desire to save rather than to invest is seeing interest rates low, and everyone is having to respond to that. They meet less frequently than us, so they chose to do it in one step. As I said before, we meet very frequently, which I think is good. We were able to do it in a couple of steps. We'll continue to look at the outlook to see whether we need to do more. It has no immediate implications for us at all.

CHAIR: Governor, you said before—and I just want to clarify that I'm getting this right—that you thought that it was prudent to model or project scenarios where you have zero rates or look at unconventional policy like quantitative easing. Is that a fair assessment?

Dr Lowe: I think, given the world we're in, it is prudent to look at these things. As I said, it's unlikely, but it is possible. The world's uncertain, and there are scenarios where we might decide that this is warranted. If that's the case, it's prudent for us to have done the work in advance to see what we would do. It's really contingency planning. We're thinking about what we might do.

CHAIR: I understand. You've just talked about looking at what you would do in those scenarios. What would a scenario look like where you decided to take zero rates, since you've just acknowledged that you are preparing for it?

Dr Lowe: You would appreciate it's difficult to speculate about this, but, if, globally, all central banks go to zero, then we would have to consider that as well. At the moment, every major central bank in the world is expected to cut interest rates over the next six months. The ECB has been at minus 40 basis points for years, and the market is expecting it to go to minus 60. The Bank of Japan has been at minus 10 for three years, and the market is expecting a decline there. There is the People's Bank of China, the Bank of Canada, the Bank of England. If they all cut interest rates, and they keep cutting—let's hope that doesn't happen, but it's possible—then we would need to think about what we would do in that scenario. We would probably need to move lower. That's one scenario.

CHAIR: Have you looked at any time frames around that?

Dr Lowe: No, I haven't. We've got market pricing for what other central banks are going to do, but the market pricing can move quite a lot quickly. I hope this doesn't happen. I hope all central banks don't end up going down towards zero. It is a possibility. I think it's a small possibility, but it is possible, and it's prudent for us to think about what we'd do in that case. I think the other scenario would be if growth in the Australian economy fell considerably short of our central scenario. We think the economy is going to pick up from here, but—

CHAIR: Considerably short?

Dr Lowe: If growth failed to pick up, and the unemployment rate started rising noticeably, then all arms of public policy would need to address how to combat that. Lower interest rates, in that scenario, would be an option, as I hope fiscal measures would be as well, from both the state and the federal governments—and a package of structural reform as well. So, if the economy isn't doing very well and the unemployment rate's rising, we'll all need to look at how to support jobs growth, and lower interest rates, and, in extremis, unconventional policy measures would need to be on the table.

CHAIR: When you say 'unconventional policy measures', let's go to QE, which is: what is the scenario that you have mapped out that would raise the possibility of going down that path?

Dr Lowe: I think I can only repeat what I said before: if all interest around the central banks is going to zero—

CHAIR: Right. It's in that circumstance and condition.

Dr Lowe: and if the economy underperforms materially our central scenario, growth is very weak—it stays in the one per cent range for a longer period of time—the unemployment rate starts rising, wages growth doesn't pick up and inflation's falling short, then we'll need to look at all monetary options, fiscal options and structural options. It's not like we're saying, 'We would do this if growth got to one per cent.' In broad terms, if the economy significantly underperforms the central forecast, then these options are going to need to be on the table.

CHAIR: Is it possible to have QE decoupled from a zero-rate environment?

Dr Lowe: It depends. If we're talking about QE as being the central bank purchasing government securities—which I think in the Australian context is the most likely form it would take—in principle, we could do that at any level of interest rate and principal.

CHAIR: Of course.

Dr Lowe: I think it's reasonable to expect that we wouldn't do it at the current level of interest rate, or even a bit below the current level of interest rate. We'd need to be very close to zero to do that.

Dr Lowe: We've got scope to lower interest rates at least a couple more times, using conventional monetary policy. Beyond that, I think we would have to draw upon the lessons that I talked about before and formulate a package that we thought was in the best interests of the country. In that world, I'd hope we were getting some fiscal support as well and support through the other mechanisms that I talked about. In talking about this, I want to make it clear that this is quite a long way from the central scenario. I think it's unlikely; it is possible, and it's prudent for us to be prepared.

CHAIR: I want to return to the paper that was raised before by the deputy chair around housing modelling, the paper by Saunders and Tulip, which found:

… that much of the strength in housing prices and construction over the past few years can be explained by the fall in interest rates …

… … …

Since its peak in 2011, the cash rate has fallen from 4¾ per cent to 1½ per cent …

… … …

The model estimates that the reduction in real interest rates accounts for most of the subsequent boom in dwelling prices …

Is the expectation of the RBA that, if we continue to drop interest rates, you'll see a proportional increase in house prices?

Dr Lowe: It's certainly possible, because one of the ways that monetary policy works is by pushing up asset prices. That's how it works, and it's no surprise to me that equity markets around the world are very high at the moment, at a time when central banks are expected to cut interest rates—and the same mechanism works on all asset prices. I think the housing market is more complicated. I think the piece of work that Peter Tulip did was very good. I don't agree with all its particular conclusions, but, in the same spirit we talked about before, we encourage our staff to look at things from different perspectives, and we think it's important they go in the public domain. The paper is right, though, in saying that lower interest rates have pushed up housing prices. I think that's pretty clear. In my own view, there are other things that are probably more important over the past decade, and they go to population growth and the slow response to that on the supply side. I think we talked about this last time—that population growth picked up in Australia quite a lot and it took almost a decade for the rate of growth of the supply to respond to that.

I'm just raising this in the context of the next phase in the housing market, because what we're seeing at the moment is quite strong population growth, which I think is good, but the additions to supply of the housing stock are slowing right down. New development is slowing down, and one of the issues we're going to keep a very close eye on over the next little while is what the supply of housing is doing. If developers cannot get finance, the supply of housing will slow a lot and we will be sowing the seeds for the next upswing. It's coming from this intersection, again, of strong population growth and the supply side that takes a long time to respond.

CHAIR: I'm just a bit confused, because there have been differing opinions between the contribution to interest rates and its contribution towards rising house prices. I almost feel like there was an inconsistency where you agreed with the Tulip paper but then said you actually think there are other factors at the same time. I draw it in the context that there's another paper the RBA did in 2019—*The Effect of Mortgage Debt on Consumer Spending: Evidence from Household-level Data*—and going back to some of the earlier questions asked about consumer behaviour. It said:

Consistent with international research, we find evidence that high levels of owner-occupier mortgage debt reduce household spending. Higher mortgage debt is associated with less spending even when we control for changes to net housing wealth and cash flow …

If we agree that the RBA is cutting rates and it is inflating the house prices, which can then have a proportionate relationship to the amount of debt, yet someone in the RBA believes that's going to have a proportionate negative impact on disposable income—I just wonder what your reflection is on that analysis.

Dr Lowe: Perhaps I can just say that, in an institution with a couple of hundred economists, you're going to get lots of different views on issues. My general approach here is not to suppress those views; it's to let people—I encourage people—

CHAIR: So you disagree?

Dr Lowe: We put material out which is going to be contradictory, but we also—

CHAIR: I don't think the data points are necessarily contradictory. I'm asking for your reflections on this.

Dr Lowe: I probably have a couple of reflections. I think low interest rates do have a significant effect on housing prices. We saw this particularly in the early 1990s and up to the early 2000s when with lower interest rates we became a low-inflation country, and financial liberalisation meant people could borrow a lot more and that got capitalised into housing prices. So, that's very clear. The recent lowering of interest rates, I think, has pushed up house prices a bit as well.

The other factor, and in my view the more important factor, is the supply and demand dynamics in the housing market over recent times. You asked about the effect of lower interest rates on people's borrowing. I do think that lower interest rates increase people's incentive to borrow and, in the end, they will have higher mortgage debt. That was one reason why we did not pursue an aggressive return of inflation to target 18 months ago—because I was worried that lower interest rates would just encourage people to borrow more and, in the end, that would be unhelpful. In the current environment, I'm not particularly worried that the lower interest rates will cause people to race to the bank and borrow more and increase their leverage. I say that for two reasons. The first is that people have already borrowed a lot, and so the same borrowing psychology no longer exists. Their income growth isn't what it used to be. People are coming to the gradual realisation of that, so their appetite to borrow is diminished. They're more likely to want to pay down debts. I don't think the lower interest rates are going to see people run off to the bank and borrow.

The other thing is that the supply of credit is still pretty restricted. The banks are being much tougher. Borrowing capacity for many borrowers, because of various changes, is down 10 or 15 per cent, so people can't borrow as much from the banks. And I'm sure you've all heard from your constituents how hard it is to get a loan from a bank at the moment and all the box ticking and form filling they have to do. The banks are not really in expansion mode for mortgage credit, and the borrowers don't want to borrow a lot more. At the moment, I'm not worried that we'll see a borrowing binge because of lower interest rates but we do need to keep an eye on that. If the economy does pick up, people are feeling good again, wage growth starts picking up and there are lower interest rates, they may decide now is the time to borrow again, particularly if housing prices are rising because the supply side's responding slowly. So, we need to keep an eye on it but today I'm not particularly worried about it.

Dr ALY: Governor, I refer to the statement of monetary policy that's just been released. Could you please go through which of the key forecasts were downgraded for 2019-20.

Dr Lowe: Can I ask Luci to answer that, because she has all the facts and figures at her fingertips.

Dr ALY: So have I. I've got the printout.

Dr Lowe: Okay.

Dr Ellis: But what I can tell you, even before I shuffle to the right bit of paper, is that our wages growth forecast has been pushed out a little. We've been talking about this all morning, but a couple of things have influenced that. Mostly it's history—the fact that unemployment is starting from a point 0.2 percentage points higher than what we had three months ago and the fact that growth has been a little bit slower than what we had expected. So that influences the starting point, and also we've been quite influenced by our liaison program, which has noted that a lot more firms are now expecting wages growth to be the same as last year rather than having a few more being a little bit above. So wages growth profile has definitely been pushed out, so that's effectively lowering. Consequently, the inflation forecast has been lowered a bit, and the unemployment forecast is effectively starting from a higher point, although it has a very similar shape. So, as we talk about in the SMP, the near-term risks are to the downside and things are looking a big soggier to the downside in the near term because of this lower starting point or this weaker starting point. But one of the things we did end up doing is that the growth forecasts in the subsequent years are actually a bit stronger, so we get back to three or a little above in 2021.

Dr ALY: Just to be clear: in the SMP, the forecasts that have been downgraded are wages growth, economic growth, GDP growth and consumption growth.

Dr Ellis: Consumption growth has been downgraded across the whole profile. GDP growth has been downgraded in the near term, for 2019, but it's been upgraded for 2021.

Dr ALY: In the SMP it says:

The domestic forecasts are conditioned on the … assumption that the cash rate moves in line with market pricing …

Then it talks about the cash rate going down to 0.75 and then possibly to 0.5 in 2020. In light of the fact that previously, Governor, you've effectively called on the government to do more to support growth through fiscal means and the limitations of monetary policy in doing some of the heavy lifting here, how effective are these projected reductions in the cash rate going to be?

Dr Lowe: Can I just clarify something: I have not called on the government to do fiscal expansion. It would be inappropriate for me to do that. I don't advise the government. What I've sought to do is lay out some options.

Dr ALY: Yes, additional fiscal support.

Dr Lowe: It's up to the government to choose from the options. People ask me about what the options are, and I lay them out, and people can ignore that if they want to.

You asked how effective lower interest rates would be. Coming back to what we talked about before, I'm confident that the lower interest rates affect the exchange rate and that helps many, many sectors of the economy, and I'm also confident that it will boost the net cash flow of the household sector. As I said before, people spend the extra money. So I'm confident those effects will work.

But we do need to be realistic here. If the global economy does take a turn for the worse, it's going to be very hard for the Australian economy to do well, so we have a lot riding on that working out well. We can play our part at the central bank, and we're doing as much as we think is responsible, but we could face difficult circumstances if the international environment goes south, and there's very little the central banks can do about that. Another perspective of what's going on is that there's quite a large political shock going on around the world. We see this in the US and China. We've got Brexit. They've got problems in Italy, and at the moment there are increased tensions between Japan and South Korea. So all these international political tensions are weakening the global outlook, and it's very hard for central banks to completely offset that. The markets will look for us to offset that, but the reality is that, if we're getting this political shock globally that reduces growth prospects, central banks can't offset that completely for the community. So we have a lot riding on these political shocks dissipating.

Dr ALY: Would you say that we could withstand those shocks if we had some fiscal support and not just the monetary levers?

Dr Lowe: It's hard to answer that, because you've really got to think about the specific scenarios. If the global economy has a very bad downturn, I'd expect our exchange rate to depreciate. That's the great stabiliser, so that would be a first-order thing that would help. We could ease monetary policy further, including some of the unconventional things we talked about before. In that environment, I would expect and hope for some fiscal support as well, but I'm not going to lay out what the specific circumstances are or what that support would look like. But, if the economy is not doing well and the global economy is not doing well, we need all arms of public policy to support the Australian economy. But that's not a call for the government to do more now.

Dr ALY: I understand.

Dr Lowe: I just want to be clear about that.

Dr LEIGH: Governor, taking into account the forecasts just released in the *Statement on monetary policy*, you expect inflation to remain below target until mid-2021, which would mean five years of missing the target. How many more years of undershooting would be required before the Reserve Bank stopped attributing that undershooting to one-off forecasting mistakes?

Dr Lowe: It's a good question. I don't characterise this as missing the target, because the target is very much the average inflation rate over time, and I accept that, the longer this period of sub-two per cent inflation goes on, the average is drifting down. I'm hoping that we can get back there. We're doing what we can, reasonably, to get back there. But we are fighting some very large global forces and some structural shifts in the Australian economy. We're committed to getting it back there. We're doing what we think is responsible to get it back there. I accept it's not as quick as many people would like, but we're doing what we think is responsible here.

CHAIR: We have discussed already today the enthusiasm to have higher wages and wage growth for the economy. What effect do you believe that continuing to increase the super guarantee to 12 per cent will have on workers' disposable income?

Dr Lowe: I don't have any comment on that. I haven't studied it carefully enough, so I would rather avoid commenting, if you don't mind.

CHAIR: All right. I'll take that as what it is. We've also had a weak currency, and the lowest level in a decade this week, which should in theory be of benefit to the economy, at least in terms of inward investment. Has there been any evidence in recent years of foreign firms shifting their operations to Australia to take advantage of the weaker currency?

Dr Debelle: I can give you one clear example. I'm not sure if I would quite characterise it as working exactly the way you talked about. Part of it is that it affects the competitiveness of Australian firms on global markets, and there are plenty of good examples around that. The drugs and pharmaceuticals industry is one clear example. With high-end manufacturing in Australia—a thing which I think is underappreciated—there has been very strong growth in exports over the past couple of years. That's going in the opposite direction to the question you are actually asking, but the effect of the exchange rate is very evident in that industry, in particular, where there has been very strong growth. That's something which has benefited this country rather than firms coming in. I suppose that has been one clear benefit to the country as a whole from the exchange rate. That said, the recent decline in the exchange rate is only recent. Going back three or four years now, we had a reasonable decline from the very high levels we had at the height of the resources investment boom. We have again seen a direct impact, I think, of the lower exchange rate there on both the tourism and education sectors in Australia. There are other things going on too, but they have been a direct beneficiary from that. So I suppose I'd answer your question slightly the other way around and just say: you can see the clear impact on parts of the Australian economy of the lower exchange rate.

CHAIR: We've talked about wage growth. Going back, and just to prove that we're all doing our research, as part of the RBA's Low Wage Growth conference, the paper 'Wage Growth Distribution and Decline among Individuals: 2001-2017' highlighted the largest determinant 'by worker characteristic is age and education'. It's a paper by Kalb and Meekes. Governor, in light of the fact that you've delivered a number of speeches looking at demographic shifts, particularly around the fact that Australia has, by comparison, one of the lower average ages in population of countries, certainly developed countries, around the world, to what extent do you think that is being reflected in the data that we're seeing, which seems to suggest there is not much wage growth?

Dr Lowe: That we're a fairly young country. I don't know; I haven't thought enough about whether that's a significant contributor. Luci, I don't know whether you've thought about that particular—

CHAIR: Has there been any modelling done by the RBA?

Dr Ellis: Can you clarify the paper you're referring to?

CHAIR: 'Wage Growth Distribution and Decline among Individuals'—

Dr Ellis: Okay; yes. This was a paper that obviously, like the other—

CHAIR: It didn't originate from within the RBA?

Dr Ellis: Yes, like the other paper from the 2017 conference that you referred to earlier, this was not an RBA paper. Guyonne presented this paper. One of the things we found, as part of that conference, was there had been a range of things that people proposed as explanations for low wage growth that can't be evidenced in the data. Part of the discussion that happened at the end of that conference was that there were a lot of suspects for the murder, but a number of them ended up being cleared. It is actually very hard to say the change in the distribution or the composition of the population doesn't seem to have been driving that, that you can see it in other factors. I chaired that session. It was a good piece of work.

CHAIR: I have a question around inflation targeting. The University of Chicago Press's Randall Kroszner recently told *The Australian* inflation targeting frameworks are based on 'faith', and the former Bank of India governor Raghuram Rajan said the QE—which is something the Bank of New Zealand has canvassed this week and we've discussed already—had little evidence to back it. He said:

If you simply look at the data, it's very hard to see an impact on long-term rates—

from the inflation target. Do you have a view on that?

Dr Lowe: Yes, I have a strong view. I think it's wrong. Remember the experience of Australia in the 1980s? We had high and variable inflation.

CHAIR: I lived through it as a child, but yes.

Dr Lowe: In the 1990s, inflation came down. Since 1990, inflation has averaged 2.4 per cent. I accept it's a bit lower than that at the moment, but inflation expectations are very well anchored. Inflation has been low and stable. Why is that? It's the monetary policy regime, partly. So, inflation targeting has provided a very strong nominal anchor for our economy. I hope Australians understand that inflation in Australia over long periods of time will average two point something—notwithstanding the recent undershooting, which I think you need to put into its historical context—and that that understanding affects people's behaviour in a constructive way. There may be other points they were making that I would agree with, but I think the idea that inflation targeting hasn't worked is fundamentally wrong. It doesn't mean it can't be adjusted here and there, but having a flexible inflation target centred around an average inflation rate of two point something has served Australia incredibly well.

CHAIR: We're now at the conclusion of today's hearing. You've survived another one. Thank you very much to all of those from the Reserve Bank who have presented before us today.

Resolved that these proceedings be published.

Committee adjourned at 13:34