COMMONWEALTH OF AUSTRALIA

Proof Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS

Review of the Reserve Bank of Australia Annual Report 2021

(Public)

FRIDAY, 16 SEPTEMBER 2022

CANBERRA

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STANDING COMMITTEE ON ECONOMICS

FRIDAY, 16 SEPTEMBER 2022

Members in attendance: Dr Charlton [by video link], Mr Hamilton, Ms Lawrence, Mr Laxale, Dr Mulino, Ms Payne, Mr Rae [by video link], Ms Spender, Mr van Manen [by video link] and Mr Wolahan

Terms of Reference for the Inquiry:

To inquire and report on:

Review of the Reserve Bank of Australia Annual Report 2021

WITNESSES

BULLOCK, Ms Michele, Deputy Governor, Reserve Bank of Australia

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

JONES, Dr Bradley, Assistant Governor, Financial System, Reserve Bank of Australia

LOWE, Mr Philip, Governor, Reserve Bank of Australia

Committee met at 09:30

CHAIR (Dr Mulino): I declare open this hearing of the House of Representatives Standing Committee on Economics for the review of the Reserve Bank of Australia annual report 2021. I welcome representatives of the Reserve Bank, as well as members of the public and the media watching the webcast.

In recent years, with the COVID-19 pandemic challenging economies and markets around the world, the importance of monetary policy for the Australian economy has never been more evident. The decisions of the RBA impact all Australians. At its meeting on 6 September the RBA board decided to increase the cash rate target by 50 basis points to 2.35 per cent and the interest rate on exchange settlement balances by 50 basis points to 2.25 per cent. It also committed to returning inflation to the two-to-three per cent range over time.

This is the first public hearing of the economics committee for this term, so I think it's very fitting that the RBA is the first organisation to be in front of us. I thank the senior members of the RBA for making the time to travel down to Canberra today.

In accordance with the committee's resolution of 9 August 2022, this hearing will be broadcast on the parliament's website, and the proof and official transcripts of the proceedings will be published on the parliament's website. Those present here today are advised that filming and recording by the media are permitted during the hearing. I remind members of the media who may be present or listening of the need to fairly and accurately report the proceedings of the committee.

I remind witnesses that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and want the same respect as proceedings of the House. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. Mr Lowe, I invite you to make an opening statement.

Mr Lowe: Good morning, Chair and members of the committee. Thank you very much for holding this hearing. At the Reserve Bank these hearings very seriously. They're a critical part of the accountability process for the Reserve Bank of Australia, and my colleagues and I are committed to answering your questions as openly and transparently as we can.

The previous hearing was held back in early February. As you would know, a lot has changed since then. I'd like to highlight three changes in particular. The first is the decline in unemployment, the second is the surge in inflation and the third is the earlier- and sharper-than-expected increase in interest rates.

In February the unemployment rate stood at 4.2 per cent. Today it's 3½ per cent. This is the lowest unemployment rate in almost 50 years. Labour force participation has also increased, so that a higher share of working age Australians have a job today than ever before. Underemployment is lower, too, as people who work part time are finding it easy to get the hours they want. I wanted to start by recounting these facts because the improvement in the Australian labour market is very significant. It's a major achievement. Australians are finding it easier to get a job than they have in a long time. Young people and women are benefiting most from this, and they have greater opportunities. Our economy and our society are stronger as a result.

In contrast, the second change since February—the increase in inflation—is an unwelcome one. When the previous committee met in February underlying inflation in Australia had just read the mid-point of the two-to-three per cent range for the first time in many years. Seven months on, we're in a very different position. Inflation has very quickly gone from being too low to being too high. Over the year to June the headline inflation rate was 6.1 per cent. It's expected to increase further over the months ahead and to peak around 7¾ per cent later this year. Inflation is then expected to start declining, to be back around three per cent at the end of 2024.

As you would know, global factors explain much of this increase in inflation. Russia's invasion of Ukraine resulted in major disruptions to energy markets around the world, increasing retail energy prices in many countries. And COVID related interruptions to global production are still rippling through global supply chains and are pushing prices up. The demand for goods in global markets has been very strong over the past few years as people switch from spending on services to spending on goods. The result of impaired supply and strong demand has been higher prices around the world, and we have felt that here in Australia.

But as important as these global factors have been, they are not the full story for why inflation is high in Australia at the moment. Demand here has been very strong relative to the capacity of our economy to meet that demand. This is clearly evident in the labour market, where the number of job vacancies is at a record high and firms are finding it quite difficult to hire workers. There are also capacity constraints in many sectors, including in the building of infrastructure and in the housing industry.

This strong demand is in part a result of the policy approach during the pandemic. During 2020 and 2021, both fiscal and monetary policy provided very considerable economic support for households and businesses. At the RBA, we did this to provide a financial bridge to the day when the virus was contained and to provide some insurance against the possibility of very bad economic outcomes in the country.

I think, as we sit here in Canberra today, it can be easy to forget how dire the outlook was in 2020. There were credible predictions that the unemployment rate would reach 15 per cent, spending in the economy was collapsing, our hospitals were expected to be overflowing and a vaccine seemed to be years away. It was a scary time—a very scary time. In that environment, the Reserve Bank Board wanted to do what it could to help and to shore up confidence. We were also seeking to provide some economic insurance against the worst possible outcomes.

In the event, vaccines were developed in record time and our economy, with the support of monetary and fiscal policy, proved to be very resilient. We did avoid the dire outcomes that many thought likely, and today many people are returning back to their pre-pandemic way of life and they're spending again, including on travel and on services. And we saw further evidence of this last week in the national accounts, with the Australian economy growing by 0.9 per cent in the June quarter and by 3.6 per cent over the year. These are good outcomes, and they're better than those being recorded in most other economies.

Given the resilience of our economy and the surging inflation, it is understandable that some people are questioning whether or not too much support was provided by the RBA over the past two years. The judgements on this issue will inevitably differ, but in those dark days of the pandemic the Reserve Bank Board judged that the bigger policy mistake would have been to do too little rather than too much. If we'd done too little and the worst had occurred, Australians would have paid a heavy price. As things turned out, thankfully, the worst was avoided, so it has been appropriate to unwind the very easy monetary conditions that were put in place during the pandemic and to address the higher inflation that has emerged so quickly.

This brings me to the third change since February, and that's the increase in interest rates from the extraordinarily low levels during the pandemic. Since May, the cash rate has been increased by a cumulative 2¼ percentage points and it now stands at 2.35 per cent. Like the rise in inflation, this increase in interest rates has come sooner and has been larger and faster than was previously expected. Previously, the RBA had forecast that the damaging effects of the pandemic on our economy would be long lasting and, as a result, inflation would stay low. On that basis, we had expected that interest rates would remain low for some years.

I am frequently reminded that many people interpreted our previous communication as a promise or as a commitment that interest rates would not increase until 2024. This was despite our statements on interest rates always being conditional on the state of the economy, and this conditionality often got lost in the messaging. We're currently working through the implications of this for our future approach to forward guidance and for communication more generally. But now that inflation is as high as it is we need to make sure that inflation returns to target in a reasonable time. A really powerful lesson from history is that low and stable inflation is a prerequisite for a strong economy and a sustained period of full employment. High inflation damages our economy, it worsens inequality and it devalues people's savings. High inflation also makes it very difficult to sustain or increase real wages, so it's a scourge.

It's for these reasons that the RBA is committed to returning inflation to the two to three per cent target range over time. I know that higher interest rates are unwelcome for many people, especially those who have borrowed large sums over recent times. Higher interest rates are putting pressure on household budgets just at the time that higher petrol prices and grocery bills are also squeezing budgets. So it's a difficult and a concerning time for many people. The alternative, though, of allowing higher inflation to become entrenched would be even more difficult, and it would damage Australia's longer term economic prospects. So the RBA will do what's necessary to make sure that the higher inflation does not become entrenched, and we are committed to returning inflation to the two to three per cent target range. And we're seeking to do this in a way that keeps the economy on an even keel. I think it is possible to achieve this, but the path here is a narrow one and it's clouded in uncertainty.

One important source of uncertainty at the moment is the global economy, where the outlook has deteriorated. The situation in Europe is very troubling, not least because of the extraordinary increase in energy prices. In the United States the Federal Reserve has indicated that monetary policy will need to become restrictive to get inflation to come back down. And the Chinese economy is also facing major challenges due to the combination of COVID, a severe drought in parts of the country and very weak conditions in the property market. I think it will be difficult for Australia to stay on the narrow path to a soft landing if there is further material bad news on the global economy.

Another factor that will determine how successfully we navigate that narrow path is how inflation expectations and the general inflation psychology evolve in Australia. To date, medium-term inflation expectations have been well anchored, and that's good news, but the general inflation psychology does appear to be shifting. It's easier for firms to put their prices up, and the public is more accepting of this.

Wage growth has also picked up from the very low rates of recent years, and a further increase is expected due to the very tight labour market. Stronger wage growth is something that the RBA had been seeking for a number of years, and some pick-up is very welcome. It is also important to note that, to date, the stronger growth in wages has not been a factor driving inflation higher and, at the aggregate level, growth in labour costs remains consistent with inflation returning to target. That's not the case in a number of other countries, but it is the case in Australia.

Looking forward now: it is important that we avoid a cycle where higher inflation leads to higher wages and inflation remaining high. This type of cycle would lead to higher interest rates, a weaker economy and higher unemployment. Businesses too have a role in avoiding these damaging outcomes, by not using the higher inflation as cover for an increase in their profit margins.

A third issue that we're watching carefully is household spending. Consumer sentiment has fallen recently, household disposable income is under pressure from higher inflation and higher interest rates, and housing prices are declining after the earlier large gains. On the other hand, many households are benefiting from the strong labour market, including by finding jobs and getting more hours of work, and some households are also continuing to save at a higher rate than before the pandemic. Quite a few have built up large financial buffers over the past couple of years, although many other households have very limited financial buffers. In the face of these competing factors, the recent data suggests that spending has remained resilient so far. Again, that's good news. Various There is, though, considerable uncertainty as to how these factors will balance out over the months ahead, and we're watching the situation very carefully.

In terms of the outlook for interest rates, the Reserve Bank Board expects that further increases will be required to bring inflation back to target. We're not on a pre-set path, though, especially given the uncertainties that I've just spoken about. The increase in interest rates has been rapid and it's been global, and we know that monetary policy operates with a lag. At some point, it will be appropriate to slow the rate of increase in interest rates and the case for doing that becomes stronger as the level of interest rates increases. As I have said previously, the size and timing of future interest rate increases will be guided by the incoming data and the board's assessment of the outlook for inflation and the labour market.

On a different matter, as you would know, the government has recently commissioned a review into Australia's monetary policy arrangements and the Reserve Bank. Both the board and the bank's staff welcome this review and we have already had constructive discussions with the review panel. We look forward to discussing with this committee the topics raised by the review at this and future hearings.

To complement the external review, the RBA is undertaking internal reviews into the three-year yield target, the bond purchase program and our approach to forward guidance. The yield target review was published in June and the review of the bond purchase program will be published next week. The forward guidance review will be published later this year.

Finally, since this is the first hearing of this committee under the 47th Parliament, I would like to draw your attention to some of the RBA's other responsibilities.

We are the banker to the Commonwealth government. We operate the official public account and are the government's main transactional banker, providing banking services to the ATO, Services Australia and many government departments. Over the past couple of years we played a really important role in making the COVID-related and flood disaster payments in real time. We made sure that people received their money quickly, often on weekends and outside of normal business hours.

We are also responsible for the core of Australia's payment system, which allows money to move from one bank account to another. As part of this work, we operate the centre of Australia's real-time fast payments system, which makes it possible for money to move between bank accounts in a matter of seconds at any time of the day or week.

We also print the nation's banknotes. While cash is being used less and less frequently for transactions, there is still very strong demand for banknotes. On average, there are 18 $100 bills and 38 $50 bills out there for every single person in Australia. The total value of notes on issue is $102 billion, which averages around $4,000 per person. That is a high figure. There's still strong demand for our bank notes even though they're not being used in transactions.

The RBA has important regulatory responsibilities in the payments system, which are overseen by the Payments System Board. We supervise the central counterparties that are operated by the ASX and that are at the heart of Australia's financial market infrastructure. We also have regulatory responsibilities for efficiency, competition and stability in Australia's retail payments system. One issue that we are currently examining closely is the public interest case for the RBA to issue a digital form of the Australian dollar, which would complement the physical banknotes that we currently issue. We have an open mind as to whether it will be in the public interest to do this. We're currently working with the Digital Finance Cooperative Research Centre on potential use cases and also working with other central banks around the world on this important issue. Thank you very much. My colleagues and I are here to answer your questions on any of this material.

CHAIR: Thank you, Governor. For the full disclosure of my financial interests, I should disclose that I have fewer than 18 $100 bills on my person at this moment! I think you have set the scene well in terms of the uncertainty which the RBA and other central banks faced at the depths of the COVID recession and the lockdowns that society has faced, and the fact that you were making decisions while having to juggle a number of possible scenarios. I think you've framed that in terms of having to think about how much insurance you would take out and if you took out too much insurance that would have consequences, but that there were reasons at the time to err on that side. In a sense you are making decisions now in the face of uncertainty as well, albeit a very different set of uncertainties. And in a sense, like other central banks, I would imagine that what you are trying to do is to return the economy to the two to three per cent inflation band, but without overshooting on interest rates and causing too much of a downturn and negative consequences in the economy. You've touched on some of these, but what do you see as some of the current risks in the global economy? For example, in the US we have a number of commentators talking about an elevated chance of the US entering recession, we have a number of issues in the EU around energy markets, and obviously in China there is a whole range of issues in their property markets and also in relation to lockdowns. I am just curious as to how you view some of those global risks?

Mr Lowe: There are three big issues and you have just touched on them there. In the US, inflation is too high, and the Federal Reserve is saying they are going to require interest rates to become restrictive and the economy to slow quite considerably to get inflation to come back down again. In large part they are saying that because wages growth has already moved there. In the United States, wages are growing five or six per cent at the moment and that is not consistent with inflation averaging two per cent, so in the United States wages growth is going to have to slow. The judgement of most people at the moment is that it is going to require a slowing in the US economy and thus much higher interest rates, and if the US economy slows that will inevitably affect the rest of the world.

The Federal Reserve are intent on communicating messaging that they would do what is necessary—the same as us—because they want to stop these lifting inflation expectations being fed through into higher wages and higher prices, so they are grappling with the same issues that we are. But as I said in my introductory remarks, we are in a much better position because wages growth is in Australia is still consistent with the inflation target. In the US it is not and that is a significant issue.

In the United Kingdom, wages growth is five or six per cent, so they have to find a way to get that back down as well. But there is a broader issue in Europe—that is, the decline in people's real incomes. In most European countries, inflation is close to 10 per cent. In the UK it will be in double digits soon. Inflation is 10 and wages growth is somewhere between three and five depending on which country you are looking at, so people's real incomes are being cut by five, six, seven per cent. When your real income is being cut by that amount, your ability to spend is diminished. If the household spending isn't there then firms won't want to invest. I think the higher energy prices in Europe are really hurting household spending ability and they're making investment environment more uncertain, so that is a clear and present danger for the European economy.

In China, they are still persisting with essentially their COVID-zero policy and are having these intermediate lockdowns in cities. That is interrupting production capability and also the incentive for Chinese citizens to spend, because they never know when another lockdown is going to come, so spending in the Chinese economy is weak. The other part of the Chinese economy that is weak at the moment is the housing sector. A number of large property developers have collapsed. They are not currently completing projects that they previously committed to, so households are unwilling to commit to buying residential property in China because they are unsure whether the developer will finish the project, so the property sector is very weak. I know the Chinese authorities are trying to support the local governments to complete projects to give people confidence that if they buy something off the plan it will be completed but they are struggling to generate the confidence there.

That is a rather long answer. The US has significant issues with getting inflation down, in Europe declining real incomes for households is a very major issue, and in China the housing market is problematic, so if you put all that together and the outlook for the global economy next year is quite weak. If it were to weaken further from our current forecasts, it will be difficult for us to navigate this narrow path of getting inflation down while having our economy continuing to grow reasonably well.

CHAIR: Another challenge with the narrow path—it has been observed by a number of commentators—is that when you increase interest rates, the impact in the real economy can take some time to materialise. You have now increased interest rates by 50 basis points a number of times. How does that affect the timing and magnitude of future interest rate rises when you might still in a sense be waiting to see the full effects of interest rate rises that are already in the system?

Mr Lowe: As I said in my introductory remarks, the fact that we've raised interest rates by quite a lot already increases the strength of the argument for smaller increases going forward. We were having interest rates at essentially zero. That became inappropriate because the economy was resilient and inflation was high. So we needed to move fairly quickly to get interest rates back to a more normal setting. We're closer to a normal setting now, which means that the case for large adjustments in interest rates has diminished. I think at our next board meeting we'll be considering whether it's a 25-basis-point increase or a 50-basis-point increase. I think it's likely we'll increase rates again, and that will be the discussion we're having, and it will really come down to how we view the balance of these risks that we've been talking about—what's going on in the global economy, how price- and wage-setting behaviours are adjusting here and how household spending is responding. But, as interest rates get higher, it's common sense that the need for big adjustments gets smaller. If all else is constant, it doesn't, but all else often isn't constant. Things are changing all the time. But at some point we'll obviously not need to be increasing rates by 50 basis points at each meeting, and we're getting closer to that point.

CHAIR: You're obviously having to constantly update your modelling. As you alluded to in your introductory comments, we had some labour force figures announced recently where unemployment was still at a low number, albeit that it had increased slightly, but total employment had increased and underemployment had remained quite low. We've had a few data releases recently. We've had our labour force figures and we've had US inflation coming in higher than expected, which obviously had a big impact on equity markets. What's your overall take on some of the data releases in recent days and whether they have upside or downside implications?

Mr Lowe: The data on the Australian economy continues to suggest our economy is doing very well. The number of job ads at the moment is at a record high. Firms tell us, through our liaison program, that it's incredibly difficult to hire workers. Job ads and job vacancies are extraordinarily high. The latest data that we have on retail spending was again pretty firm. And we have high-frequency data from the banks and the card companies about the current growth in spending, and it continues to suggest that spending in the economy is pretty strong. So spending is strong, firms want to hire workers, workers are getting jobs and they're getting more hours. The NAB business survey—I think it was earlier this week—again showed businesses are confident. A counterbalance to all this is that consumer confidence is very, very weak. We're in this environment at the moment where consumer confidence is weak but people keep spending. Partly it's because the saving rate is still high, so people have the ability to smooth through the weaker growth in real incomes, but it's one of the puzzles at the moment: spending is strong but consumer sentiment is quite weak. How long that will last for it's hard to know.

CHAIR: The last question on your overarching take on the current situation is: what's your central forecast for the likely overall impact on average housing prices across Australia?

Mr Lowe: We don't really have forecasts of housing prices. It's so hard to forecast asset prices, isn't it? But prices went up 25 per cent over the past two years—a very big increase. This is not a forecast, but it would not surprise me if prices came down by a cumulative 10 per cent. Even if they did that, they're still up 15 per cent over three years. It's hard to know. As I said, we don't want to forecast housing prices, because it's very, very difficult to do. But, as interest rates rise further—and they will rise further—I'd expect more heat to come out of the housing market and prices to come down further. We've got to remember that prices went up 25 per cent in two years. A while ago people were complaining that housing prices were rising too quickly. So, as a society, we're either complaining the prices are going up or going down!

CHAIR: Looking back at some of the policies that the Reserve Bank implemented over the last couple of years, I have a couple of questions, firstly about forward guidance. You talked in your introductory comments about the fact that at no point did you make a guarantee in relation to where the cash rate would be. If you look back at some of your specific comments, for example, in October 2020 you said:

> So we do not expect to be increasing the cash rate for at least three years.

And in September 2021 you said:

Our judgement is that this condition for a lift in the cash rate will not be met before 2024.

And on 16 November you said:

It is still plausible that the first increase in the cash rate will not be before 2024.

So each of those statements does, as you've identified, have a caveat in it. They have conditionality.

I'm just curious though, about lessons learned and the way that forward guidance may be implemented in the future. It does seem as though, notwithstanding those caveats, some both in wholesale markets and in the broader community focused more on the date than on the conditionality. I'm just wondering. I have two questions. One is: if forward guidance were to be used in the future, would it be best to have a shorter horizon? Secondly, would it be best to use vaguer language—so, rather than putting a specific date out there, to use language like 'for some time'?

Mr Lowe: They're very good questions. The Reserve Bank board is going to have a full review of the experience of the past couple of years at its November meeting, and I'll have more to say later in the year on how we're going to do this going forward. But perhaps I can just outline for you our general approach.

We start off providing forecasts for the economy. People expect us to provide forecasts. Those forecasts always have a lot of caveats, but, rightly, the community expects us to put our central forecasts out there, so we do that. The next thing we do is try and explain our reaction function—how we're going to move interest rates in response to various variables. So we put forecasts out there, and hopefully people understand our reaction function. Up until the pandemic, people would then draw their implications for what that meant for the timing of interest-rate increases. That's how it has worked for a long period of time.

During the pandemic, we put our forecasts together with our reaction function to be very explicit about what we thought that meant about the timing of interest rate increases, so that was quite different. In the past, we left judgements about timing to be drawn by the market and by the community. During the pandemic, for better or worse, we took the extra step of putting the forecast together with the reaction function and making explicit statements about timing, even though they were caveated.

Some people think that was a mistake, and it may well have been, but what we were trying to do there was to send a very strong message to the community that the Reserve Bank would do what was necessary to keep the economy as strong as it could be. It was scary. It was a difficult time, and we wanted to use every instrument in our toolkit to provide support for the country. We wanted to provide insurance against the possibility of a very bad outcome. We thought that one way we could do that was to be more explicit about what our forecasts and our reaction function meant for the timing of interest rate increases. It was a unique period in our economic history, and the communication responded to that. We wanted people to understand that we thought the pandemic was going to be damaging to our economy but the Reserve Bank would be there with them. We would keep interest rates low for however long it was necessary to get us through this.

CHAIR: Just on that very issue, I think you've said that you wanted to communicate to the community very clearly. One thing that struck me is that, ordinarily, running through the details of Reserve Bank statements might be something you expect bond traders and people in wholesale markets would do. It did strike me that, particularly at this time, people in the community were following very closely the statements of the Reserve Bank, so you had both wholesale markets and, indeed, international markets and people in the community following it. In recent times, a lot of people in the community have said that they acted in reliance upon that. So I'm just interested: how do you assess the ways in which people are relying or acting upon your statements in what you might call retail markets or in the broader community and in wholesale markets? That might be different, of course.

Mr Lowe: When people are taking their individual decisions, they're drawing information from a whole range of sources. They would draw information from what the Reserve Bank says, but we're only one voice out there. But I do note that over recent years a lot of people took out fixed-rate loans. In most years in the past only 10 per cent of the population—less than 10 per cent of the population—taking out a mortgage took out a fixed-rate loan. During the pandemic years that went to almost 50 per cent. With the flow of new loans, almost 50 per cent of them were fixed-rate loans, and people were often taking out two- and three-year fixed-rate loans. That was partly because of, I think, our communication, that the fixed rates for three years were very low because of our various policy measures.

So people did respond sensibly in taking out fixed-rate loans during that period. They were prepared to go and buy property or undertake other investments because they could get fixed-rate money for three years. We'll see the other side of that starting from next year, when those fixed-rate loans roll off. But people did, no doubt, take heed of what we said, and we wanted them to. The community took the message that interest rates were going to stay low for a long period of time. Our underlying message was that the Reserve Bank would be standing with the community to do what was necessary to support the economy. We thought that meant interest rates were going to state low for a long period of time. That hasn't turned out to be the case, and it's because we've done well. But the message, particularly through 2020 but also into 2021, was, 'These are difficult times, the central bank will be there to support the community and will do whatever is necessary to support you.'

CHAIR: But it appears that relying on, as you said, a number of sources—but this was a key one—

Mr Lowe: Yes.

CHAIR: It does highlight the importance of the way in which statements are framed.

Mr Lowe: Yes. Sorry, can I just make one other comment in response to your previous question? We drew together the forecast of the reaction function for the timing of interest rate increases. That was in a unique period in our history. We will be much less inclined to do that in the future, but I still think it was the right thing to do in that time. Others disagree with that, but I don't think it's going to be part of the regular way we're operating. As you suggest, our language about the timing will be vaguer—as I've tried to be today.

But, on the other hand, people want clarity, don't they? So we're in a difficult position often, because people say, 'Well, what are interest rates going to be in a year's time?' We don't know, but what we can give you is our forecasts in our reaction function and then you'll have to make your own judgements about that.

CHAIR: You've highlighted the fact that there has been some soul-searching, and one of the areas where there has been soul-searching is in relation to forecast misses. But, as you've pointed out, you weren't alone in not correctly forecasting inflation. I think it's well known that forecasting is difficult at the best of times, but trying to forecast turning points in particular is extremely difficult. But what have you done in light of that initial soul-searching, and perhaps in conversations with other forecasters, to strengthen models?

Mr Lowe: I'll ask Luci to talk about that. Just before she does that, I'll just remind you that in August last year most central banks thought that inflation in 2022 would be between two and 2½ per cent. That was the consensus amongst the professional forecasting community. They thought that this year inflation would be two to 2½, and yet in almost every country in Europe it's eight, nine, 10 or 11. In the US it's nine, in Canada it's eight. So everyone has got this wrong and the Reserve Bank has got it wrong as well. When we make forecast errors of this magnitude it's incumbent upon us all to look back and ask: 'What could we have done differently? What do we learn about that?' We're currently going through a process in the Reserve Bank to understand why we made such a big forecast error and how we can improve our processes. But, if it's okay, Luci could talk about that a bit.

CHAIR: Sure.

Dr Ellis: Thanks, Phil. Because it is impossible to forecast perfectly, we always have a process where we evaluate our past forecasts, take lessons from those and report those to the board each November. So, in some sense, this is our normal process of reflection and re-evaluation, but it is something that we will be doing with extreme vigour this time because of the scale of the forecast errors that we've had—not just over the course of the last 12 months but over the course of the pandemic—and making sure that we understand how to interpret the shocks that come through.

One of the perspectives we're taking in that analysis is that we're trying to disentangle the pieces you can't possibly forecast. No, we didn't forecast that Russia would invade Ukraine when it did. We can't really say, 'Well, we should have forecast that.' The question is how much of the forecast miss is due to those generally unforecastable events versus our lack of complete understanding of what the implications of that event were once it had already happened. We were correct in understanding that that event meant gas prices in Europe in particular would increase, that they would increase more than in Asia and, in turn, more than domestically, because the gas markets globally are not fully connected and so there is not pure price arbitrage. We knew that. What we didn't fully understand was that the transmission through coal prices was going to have a whole range of effects on our own electricity market—so our initial assessment of what this would mean for electricity prices domestically was not quite right. Should we have understood those dynamics in the electricity market better? That's just one example.

I just want to roll back to where we were in the August or November forecast rounds last year. As Phil mentioned, everybody was expecting inflation to be, at best, in the bottom half of the two to three per cent range—two to 2½. If you look at the range of private sector forecasters during that period, that's exactly where they were; we were right in the middle of everyone else's forecasts. If anything, we were a little more bullish on GDP in some of those forecast rounds, and people were pooh-poohing us for that. I don't think we were any better or any worse in understanding those things. But think where we were in August: two of the major cities were still in lockdown; the vaccine campaign was not going particularly quickly at that point; we had genuine doubt about whether we would be out of 'lockdown world' anytime soon. Our August forecast did assume there would be further lockdowns elsewhere in Australia at some point during 2022; that was built into our forecast—maybe not four to five months, but we assumed there would be further restrictions elsewhere in the economy. That didn't happen. And omicron hadn't happened at that point; it didn't emerge until late November. The epidemiology of what happened was not something we could forecast. So these are all things we're looking for.

The other thing we're doing is increasingly using new datasets. There has been some material improvement in our approach particularly to near-term forecasting. We published a *Bulletin* article a couple of quarters ago about our new consumption tracker. We're actually getting a lot better at forecasting consumption than we used to be because we have a lot more sources of near-term information; that's worked out particularly well. But whether it's the payments data the governor mentioned earlier or our liaison—we've always had our liaison program, for 21 years; we released a *Bulletin* article talking about that yesterday. We've been using that very systematically to make sure our various sources of information are being triangulated appropriately. In the end, the question is: how much of this was 'we couldn't have predicted Russia would invade Ukraine, we couldn't have predicted omicron would emerge'—those are things you can't predict—versus 'here are things that we maybe could've understood better once those events happened'? That's the question we're posing to ourselves, and we'll be reporting to the board in November.

CHAIR: Thanks a lot. I've got some more questions, but I'll wait to see if there's time at the end.

Mr HAMILTON: It's good to meet you all. You've touched a fair bit on recent challenges, decision-making and some of the communications we've been through. I'd like to follow another line from your opening statement, Governor, about the role that fiscal policy can play working with monetary policy. You talked about those two working well together. It's a bit of an open question, but I invite your comments on it: what might that look like, given the outlook you've presented for us today?

Mr Lowe: During the pandemic the Reserve Bank and the government worked very well together. There was very strong coordination between fiscal and monetary policy. I had many meetings with the government. It was a good process of consultation and shared knowledge. From where I sit, that was a very constructive process, and the country benefited from it.

Outside crisis periods there's less explicit coordination of monetary and fiscal policy, and I understand why that's the case. At the moment, I don't have any particular concerns about the setting of fiscal policy. We've got a budget coming up in a month's time, so we'll be looking at that very carefully. My main observation on fiscal policy is really a medium-term one. There is significant issue there. At the moment, we're the closest to full employment we've been in 50 years and we've got the highest terms of trade ever in Australian history, yet we've still got a budget deficit and are projected to have a budget deficit. That's a significant issue. The community wants the government to provide a whole range of services, understandably. We want really high-quality aged care, great education, world-class disability clear, fantastic national defence, great infrastructure. The community wants all these things from our governments—it's understandable. What we haven't worked out as a community is how to pay for it, and this is why we've got these budget deficits despite full employment and the record terms of trade. At least in principle, there are three ways that you can pay for it. You can raise more taxes to pay for the things the community want. You can cut back in other areas. Both of these things are very difficult. No-one wants to pay more taxes and no-one wants cutbacks in other areas. Or we can get the economy to grow more strongly so the pie is bigger, and that requires hard choices on a whole bunch of structural reform issues. Each of those are very difficult, aren't they? Taxes, cutting back and structural reform—we have to do one of those three things, maybe all three of them, if we're going to pay for the goods and services that the community wants from our governments.

That's my medium-term fiscal issue. It's not really bearing on the current setting of monetary policy—I have no issues there—but I do worry how, as a community and society, we're going to tackle this need to pay for the things that we as a community want the government to deliver for us.

The best option here is to do structural reform, to have a bigger pie, so there are more resources to pay for aged care, disability care, great education and defence, but that requires both governments and businesses to do things that are difficult.

Sorry, that's the end of my comments on fiscal policy. At the moment, I have no particular concerns, and we're waiting for the budget next month.

Mr HAMILTON: Forgive me for teasing further, are there things you'd be looking for that would potentially put at risk the successful deployment of the monetary policy that you're looking for? You've raised those three areas that you'd expect us to work into. If we weren't addressing those areas, would that potentially prolong the period for which we'd have to deploy higher rates?

Mr Lowe: We're talking really hypotheticals here. There's clearly a setting of fiscal policy that would put more pressure on us to push up interest rates. If we had another significant fiscal expansion at a time when the economy was doing well and business couldn't find workers, then that would put upward pressure on interest rates. It's not my expectation that it will be in the budget, but we'll wait and see. My focus here, really, not just as the governor of the central bank but as an Australian is how we pay for these things, because we can't pay for these things on the national credit card. We shouldn't be. There are better ways of doing it. Whether this budget is the time to start that process—there'll be another budget in May, I understand—I would hope during this term of parliament that you could start addressing probably each of these three things to pay for the services that our community want.

Mr HAMILTON: So I guess a tightening of settings would be expected from your side.

Mr Lowe: I don't have particular expectations about what would be in the budget. As we all know, the community is suffering cost-of-living pressures. There's pressure on the government to aid people with that. That's understandable. How far the government goes in that direction I don't know, but I'm not concerned that there's going to be some change in fiscal policy in the near term that's going to make our job more difficult.

Mr HAMILTON: Addressing the issues paper, one thing I'm interested in is the theme of holding board members accountable to their individual votes. In general terms, what would be your view on the impact of that? Are there positives and negatives to it? What else can we see through just that headline?

Mr Lowe: There are positives and negatives. In many countries, the board members, or the people making decisions about interest rates—their individual votes are recorded. Our board is unusual in the fact that it comprises largely outside people. Michele and I are both board members, but the other seven board members do not sit inside the central bank. In most other countries, the people taking decisions about interest rates live in the central bank or spend most of their time in the central bank, and they're expected to be individually accountable for their votes. I think the structure of our board has led us to a different situation, where the board members—seven of them—don't spend their life in the central bank. I think that's good that they don't, because I think that brings a diversity to the decision-making process that you don't get if everyone making the decision lives inside the central bank.

But the board has decided that it doesn't want to record individual votes and that I, as the governor, am the spokesman on monetary policy. Historically that was partly because there was a sense that the board members, if they had individual votes recorded, would be subject to more lobbying, and, if they represented, or were seen to represent, a certain class in the community, there'd be lobbying. And—this is very clear—they do not see themselves as representing certain segments of the society; they're there to represent the 26 million people who live here. Their judgement has been, to date, that, by not recording individual votes, it's easier to take the perspective of the 26 million people, rather than being associated with some particular group. None of that is to say that a regime in which individual votes are recorded wouldn't work. It works in some countries, and, if my board decided that's what they wanted to do, I'd be perfectly relaxed with that. So there are pluses and minuses here, and there's not one system that's better than another really.

Mr HAMILTON: On confidence in communications—and I note your search for nuance in communications and I wish you good luck in that—

Mr Lowe: Thank you.

Mr HAMILTON: I think everyone here would like to find that magic elixir. With regard to where interest rates have been in recent times—and we're seeing the rate rises now—what's a reasonable view? Will they be returning to these sorts of periods? Should people have that expectation? It seems there's a strong push back against interest rates rising, but realistically where are they rising to? Is this more of a normalised setting? Should people be expecting them to return lower?

Mr Lowe: Well, I hope they don't return lower, because that would mean the economy is weak. It's a good question, but it's a difficult one. I think what I can say is that the midpoint of our inflation target at the moment is 2½ per cent, so, if inflation averages, over the next 10 years, 2½ per cent, you would expect the cash rate average to be at least 2½ per cent as well. If it isn't, then, on average, you would have a negative real rate, and the risk-free rate wouldn't be compensating people for inflation. That would only happen if productivity growth was weak and the economy was weak. The interest rate should at least average the midpoint of the inflation target. I suspect it should average higher than that, because, if there's productivity growth in the economy, that should lead to a higher real interest rate. If we can generate one per cent labour productivity growth, which I hope we can, then you would expect the average interest rates over long periods of time to be equal to the inflation rate plus the rate of growth of productivity. So that would be averaging an interest rate of three per cent—possible—and we would see movements around that with the economic cycle. And we would only see rates come back down to close to zero if we had a sharp downturn again. But I think we'll cycle around some number between 2½ and 3½—it's hard to be specific—and we'll cycle up and down that with the economic cycle. We're closer now to that, aren't we? We're 2.35, so we're getting to that range that you'd think is normal but probably still on the low side.

Mr HAMILTON: Maybe this is a follow-on, but comments in your opening address were about 2020 being a dire outlook ahead. How would you describe our outlook now?

Mr Lowe: I would say uncertain, but still positive. We're expecting growth in the economy to be reasonably good next year, with some modest lift in the unemployment rate. But the key perspective is that for the past 50 years, if we'd had an unemployment rate of four per cent people would have said, 'Fantastic!' Underemployment is low; people are getting jobs and getting the hours. Female labour force participation is at a record high and the youth unemployment rate is the lowest it has been in many, many decades. So even if the unemployment rate comes up to four per cent from 3½, those things will all still be true. You've got to remember that.

The Australian economy for the last 30 or 40 years has done remarkably well, but I've always thought that one black spot in our economy was that people couldn't get the jobs and the hours that they wanted. We've struggled to get to full employment, and we're as close to full employment now as we've been in 50 years. So that's fantastic news for people, because getting a job and getting an education are the two critical steps on the ladder of success for most people—and most people in the country can get a job today. The number of job vacancies is very high, so I think that over the next little while we're expecting the unemployment rate to come down further and then gradually lift. So the outlook for the labour market is strong and it's as strong as it has been in decades. That's really good news.

The uncertainties, really, largely come from the global economy, and we've talked about those. The other thing that I had been concerned about was the possibility of the inflation psychology shifting, that in this period of higher inflation we're having, where inflation is going to go to seven per cent plus later in the year, the view would take hold that wages need to be fully compensated for that. If that were to happen, as I said, we'll have a very difficult time. I don't think it's going to happen; at the moment wages are not driving inflation and the aggregate growth of wages is consistent with inflation returning to target. But whether that stays the case is an uncertainty because the labour market is really tight, isn't it? Firms are finding it hard to get workers, and wage growth is picking up as a result of that. I know it's a difficult message, but if wage growth picks up to compensate people for full inflation we'll have a lot of trouble. I'm hopeful that we don't. In the US and the UK, wage growth is picking up to compensate people for inflation and that's one reason they're going to have trouble. I hope we can avoid that.

Mr HAMILTON: I have one last question, I guess to focus on business. I know this is only anecdotal, but amongst the big businesses in my community if you talk about wage growth they'll say, 'No, no, talk about payroll.' Their total labour costs have increased 10, 15 or 20 per cent in some cases, depending on the industry—particularly the construction industry has gone through the roof. At a tangible level for them, whether it's wages or money going out otherwise it's still an increased cost that they've felt.

Coupling that thought with your comment around businesses needing to make some difficult decisions—and, forgive me, I'm not throwing your words back at you but asking you to expand on it—and not seeking to increase their profit margins during this period.

Mr Lowe: Yes.

Mr HAMILTON: Is that a realistic expectation on business, given those increased costs that they're already feeling—although, be that not through wages but through payroll?

Mr Lowe: In very broad terms, inflation can from three sources. It can come from higher input costs, and we've seen that with higher electricity prices and raw material costs. So it can come from higher input costs. It can come from higher wages and it can also come from higher margins. To date, it's largely from higher input costs. There's some pickup in wages, but that's not driving inflation, and I think in some industries there has been an increase in margins. In a way it's not surprising, when the demand for goods has been so strong over recent years, that firms don't discount as much. When the supermarkets were having to close because people couldn't get things; there was so much demand, they weren't going to discount. I think that discounting in retailing has diminished, and that discounting in a number of industries has diminished. Many firms tell me that they want more workers. They don't want more customers at the moment. When that's your mindset you're going to push your margins up, aren't you? It would be strange if you didn't. So that process shouldn't go too far. I don't think it has at the moment, but it's just kind of sounding a warning. We have to be careful there, because inflation doesn't just come from wages, it can come from profit margins as well. And part of the slowing in the economy that we are expecting and the rise in unemployment will probably put a bit of pressure on profit margins in some sectors as demand slows. I'm not saying there is gouging at the moment, but we've got to make sure that simple high-profit margins don't become a source of inflation. I don't think it's going to happen but it's possible.

ACTING CHAIR: Are you relying upon a change in that?

Mr Lowe: I think for inflation to come down and to navigate this narrow path we are relying on wage growth not picking up too much more, it's a difficult message, and relying on profit margins not rising further—in fact, coming back a little bit in some industries as demand stabilises. We're relying on both those things. I called them out of my introductory statement, because we need to see those two things. I know it's not a comfortable message for people that we're going to have a decline in real wages this year. It's tough. When interest rates are rising and real wages are declining it's pretty tough, isn't it? But next year, if our forecasts come to pass inflation will be a bit above four, and the broadest measure of growth in wages—which is from the national accounts average earnings per hour worked—will be close to five. Next year we are expecting real wages to be positive and the following year to be even more positive. This year it's negative, wage growth is much less than inflation, and that's really tough for people. But if we hold together on these two things we've just been talking about, growth in our real wages and profit margins, then next year we can look forward to growth in real wages again.

The alternative is for people to get full compensation for inflation this year. What do you think inflation will be next year? If inflation is seven this year, wages are seven to compensate people, what's inflation going to be next year? High. And if you need wage compensation for that, again, what's it going to be the year after? High. We will respond to that prospect with much higher interest rates and a marked downturn. I know that having a decline in real wages this year is difficult but it's better than the alternative. Next year real wages can be positive again.

ACTING CHAIR: I may not share your confidence on that profit reduction but thank you very much.

Mr Lowe: I don't know how confident I am. I'm just raising it as an issue. I have one final comment here. Some slowing in growth in aggregate demand will put downward pressure on profit margins, won't it? Because there will be more discounting. So that's partly how higher interest rates work. It's not just affecting wages; it's affecting the amount of discounting that occurs in the business sector and the profit margins. At the moment, many business people tell me that they want more workers and they don't want more customers, so you are going to put your prices up, aren't you? You would be crazy not to. We have to get recalibrated to where at least some businesses are again saying, 'I'd like some more customers and perhaps I'm going to discount to get them.'

CHAIR: Thanks, Deputy Chair. I will hand over now to Dr Charlton.

Dr CHARLTON: Thank you, Chair. You noted that interest rates have increased substantially recently. You also said that as a result of those substantial increases interest rates would be going higher but potentially at a slower rate. I think your words were that we're getting closer to normal settings. In response to a question from the deputy chair you gave a view on what those normal settings might be in nominal terms. When you think about those normal settings do you think about rates in nominal terms or in real terms?

Mr Lowe: We start off thinking about the neutral real rate. So that's in real terms. But we set a nominal rate, don't we? So we have to translate the real rate into a nominal rate. The way we do that is adding on a measure of expected inflation. I expect that over time we will hit the inflation target of 2½ per cent. We translate the concept of a real rate into a nominal rate by adding on 2½ per cent. The neutral real rate is subject to a huge amount of uncertainty, and next month, I think, Luci is going to give a speech outlining all of the various models we use to come up with our estimates. But my reading of the evidence is that it's likely that the neutral real rate is at least positive. It would be a pretty sad state of the world if the neutral real rate were negative. It's possible because of demographics and other things, but I think it's unlikely. If you start from that, saying that the neutral real rate is at least zero and add 2½ per cent, the normal level of the normal rate is 2½ per cent. As I said in response to the deputy chair's questions, I hope it's higher than that, because I'm optimistic about productivity growth.

Dr CHARLTON: Thank you. If, as you say, the neutral real rate is positive, what does that mean the real rate is today?

Mr Lowe: It's still negative because the nominal cash rate is 2.35 and inflation is likely seven and expected inflation over the next couple of years is higher than 2½ per cent. But long-term inflation expectations are still anchored at 2½ per cent. If you use a measure of longer-term inflation expectations, it's only very marginally negative. This is one of the reasons why we think we need to go further. I think the 2.35 rate is still too low.

Dr CHARLTON: If I am understanding you correctly, that means that today the real rates is, I think you said, something like six per cent inflation and forecast to rise up to seven per cent. That would mean we're at about 400 basis points. Am I doing the mouth right?

Mr Lowe: Yes, you take the nominal rate minus inflation expectations. It depends on which measure of inflation expectations you want to use. If you use the expected inflation over the next year—well, we are expecting inflation to be at four per cent in 2023.

Dr CHARLTON: My question is about today.

Mr Lowe: Yes, you're right.

Dr CHARLTON: Today's real rate is like minus four per cent?

Mr Lowe: Yes, 2.35 minus seven. But I wouldn't draw the conclusion that you have to get rates up to seven per cent to get to a neutral nominal rate, because inflation expectations over the medium term are much lower than that. So I wouldn't draw that conclusion from that maths.

Dr CHARLTON: When you said earlier that we're getting close to a normal setting and real rates today are something lower than minus four per cent, that feels like quite a long way away from what you described as the neutral real rate of something positive.

Mr Lowe: I am back on this measure of inflation expectations. I am inclined to subtract 2½ from the nominal rate to get the estimate of the real rate. 2.35 minus 2½ is just a small negative number. If we have a few interest rate increases over the coming months, it will start to get more positive. You can do these calculations lots of different ways, but I don't think it's the right thing to do to use the current inflation rate in calculating the real interest rate.

Dr CHARLTON: Why is that? Why would you not use the current inflation rate rather than what I think you seem to be using, which is a view of inflation expectations for some period?

Mr Lowe: It is because, if you use the current inflation—let's say seven per cent, which is what it will be later in the year—to have a neutral setting of interest rates in Australia, you would need the cash rate to be at least seven per cent. My judgement and the judgement of most of my colleagues is that that would be incredibly contractionary for the economy and would throw us into a sharp recession. So I don't think that's the right way of thinking about what the neutral nominal rate is at the moment.

If you thought inflation was going to stay at seven per cent, it'd be exactly the right calculation to do. If businesses thought they were going to be able to put their prices up by seven per cent every year for the next five years, and the interest rate was 2.3, it would be way too low, wouldn't it, and things would be going crazy. But, at the moment, most people think that in a few years time inflation will be back to two point something. So if you're borrowing for over the next ten years, you're not thinking that inflation's going to be going up at seven per cent every year. If you did, then interest rates have to go up a lot.

This is why inflation expectations and inflation psychology are so important, and why I want to remind people how serious we are at getting inflation back down. If you don't believe we are serious about getting it back down and will do what's necessary, and you believe inflation is going to be seven per cent for the next five years, then interest rates have to go up a lot, and we don't want that.

That's a long-winded answer, but this is why I don't think it's the right thing to do to take seven per cent off the current rate. You would only do that, when you are making borrowing decisions, if you're factoring a seven per cent increase in inflation year after year. Really, I hope people don't do that.

Dr CHARLTON: Sure, but that is the current real interest rate

Mr Lowe: As defined by you, yes. It's the nominal rate minus expected inflation—so, as you've defined it, yes. But don't draw the conclusion that we have to have a nominal rate at seven per cent to keep the economy in balance.

Dr CHARLTON: I'm not drawing that conclusion, but I am asking you the question. Your calculation of the current real interest rates seems to be relating to what you hope—for want of a better word—the inflation rate will be in a couple of years time. We've had significant challenges with forecasting inflation. We don't really know what it will be. As you say, we have a view on inflation expectations, but those inflation expectations have not been a very good guide for what inflation is going to be over the recent period. What we do know is what inflation is today. You also said that in order to get down to a lower level of inflation we will need to have demand slowing. So how do you reconcile a current real rate that is something lower than minus four per cent with the slowing of demand in order to achieve the inflation rate that you are putting into your model for the medium-term real inflation rate?

Mr Lowe: There are a few points. It's more than a hope that inflation is going to come down. I certainly hope it's going to come down, but most measures of inflation expectations, through the relevant financial markets and people who are making their livings by betting what inflation is going to be, are predicting that within a few years inflation will be back with a two in front of it. That's the collective judgement of people making investment decisions. But we have all been wrong before, so we could be all wrong again. And if we are wrong and inflation does stay high, then we're going to face much higher interest rates. So let's hope that doesn't happen.

Why is inflation going to come down when the real rate is minus 4 in your calculation? It's a good question. There are a number of factors. First is that most people don't think inflation is going to stay at seven per cent, so they're not factoring that into their decision-making process; they're factoring in increases of two or three per cent. But, probably more fundamentally, what we're seeing in global markets at the moment is an increase in supply and a reduction in demand for goods. In the United States, in one single you during the pandemic, total demand for goods rose by 20 per cent. Just in one year, the demand for goods rose by 20 per cent. And that was just at the time that the global supply chains were impaired. So, even if they hadn't been impaired, the system couldn't have coped with that. People couldn't travel, they couldn't go to restaurants or the theatre or the football or whatever, so they sat at home and bought goods for the house. That put huge pressure on global supply chains, and in response—the discussion we were having before—firms put up their prices. Why wouldn't you, if demand was going so quickly? That added to the inflation impulse a lot in the global economy. Shipping times blew out. Shipping costs blew out. That's all now in the process of reversing. Demand for goods in the US really hasn't grown for six months. Shipping costs are coming right back down. Waiting times for delivery of imports are coming right back down. So that's taking inflation pressures out of the system.

Another thing that's helping is that commodity prices are coming off again. As the outlook for the global economy has deteriorated, commodity prices have come down. And the big increase in commodity prices that we saw after Russia invaded Ukraine has been reversed. There was a huge amount of media coverage of the big increase in wheat prices. That's all been reversed now. There's been a good harvest in Australia, and in North America, I think. Some of the panicking that took place after the war started has reversed.

Commodity prices are coming back down. The global balance between demand for and supply of goods is fixing up. Those things are going to bring inflation back down. Remember inflation is the rate of change of prices. So, even if prices stayed at the higher level, the rate of inflation goes to zero for those goods. If prices actually come down, we get negative contributions. We see this in the price of petrol at the bowser. Last year it went up 32 per cent in Australia. That added, I think, a per cent and a bit to the CPI. Let's hope it doesn't go up another 32 per cent. I think it's probably going to come down. The cost of building a new home went up 20 per cent—probably not another 20 per cent this year.

So there are things going on—and the supply-demand balance in particular industries—that give us hope that inflation will come down. As long as profit margins don't rise too much and as long as wages don't rise too much, inflation will come back down. That's my central view, and I think that's eminently plausible and credible. But we've made big errors before and no doubt will make them again. But at the moment the view amongst the central banks and the paid forecasters in the financial markets is that inflation will come back down again, partly for the reason I just talked about.

Dr CHARLTON: This is my last question, Governor. We're in a period—at least currently—of very loose financial conditions, with real rates that are somewhere below minus four per cent. In the answer you just gave you said that, in your view, the real rate should be thought of differently, based on your expectation that inflation will be coming down, and then you said the two main factors for why inflation will be coming down will be supply-side factors and commodity price factors. I think you and the deputy governor said in earlier answers that they were two of the hardest things to forecast—two of the things in which we have had the largest forecast errors. In that case, does it give you some concern that your view of what the real rate might hope to be or, to use other language, expect to be has a lot of uncertainty around it and in fact our current rate of real interest rates is a long way from what you think is neutral?

Mr Lowe: Yes, you're right; there is a lot of uncertainty there. You pointed to the two parts of the answer. I could have extended my answer about why inflation is going to come down: the higher interest rates are crimping spending in the economy, and the effect of that is going to build. So in our domestic economy we're going to get a better balance between demand and supply. We talked earlier in the hearing about the uncertainty in the global economy. There's quite a lot of negativity about the global economy. Just this last weekend I was in Basel, in Switzerland, with the central bank governors, and, for the reason we talked about before, there's quite a lot of concern about the global economy. So the supply side is fixing up, commodity prices have come down, we're raising interest rates and the global economy is looking a bit fragile. Those things will, I hope and expect, bring inflation down.

If all that's wrong and inflation stays high, then interest rates are going to have to be higher. Really, for the calculations you were just saying, if inflation turns out to be six per cent or seven per cent again next year, interest rates are going to have to be much higher. I don't expect that to happen, but unexpected things do happen, don't they?

Dr CHARLTON: Thank you very much, Governor. I'll hand back to the chair.

CHAIR: I now suspend the hearing for a short break.

Proceedings suspended from 10:49 to 11:00

CHAIR: I now resume the hearing.

Ms SPENDER: Thank you for your comments today. You raised, I think, a really interesting challenge that we face right now in the sense that we have, as you say, full employment, record terms of trade, a structural deficit and the opportunities that we have in how we address those over the longer term. I would be really interested in your thoughts on some of those key structural reforms that you think we should be considering in this space to drive productivity.

Mr Lowe: It is a good question. It is not really my core area of competence but I note that the Productivity Commission now is doing its five-year review. The last one it did was called *Shifting the Dial*. It was back in 2017 and it had a lot of very good suggestions about the way we design our cities, the way that public services are provided by the government. That report had a lot of good ideas; not all of been implemented. But the list of areas where reform is needed is long.

I have a few notes here but these are points that others have made. The taxation system—the combination of taxes on land, income, consumption, natural resources and savings: anyone who looks at that doesn't say we have the optimal system—in fact, they say we are a long way from optimal on most of those areas, so that is an issue for the parliament that is very difficult; the way we select and price infrastructure—there are improvement opportunities there; the way we train our people who work in Australia—the cumulation human capital starting at preschool and going right through to university; the way we regulate the energy system—we probably haven't nailed that; the complexity of the regulatory system; the rewards we establish for renovation; and the way we train our people to use data, protect data and take advantage of data. These are all areas where Australia has huge opportunities. If we put our collective shoulders to the wheel then we can do this but it requires reform from both government and businesses. It is not just government to do it; businesses have to step up in each of these areas as well. There are plenty of reports that give us good suggestions. As I said to committees previously, the issue isn't what knowing what to do; it is developing the political and other capability to do it.

Ms SPENDER: Professor Warwick McKibbin has argued that climate change impacts are likely to lead to more frequent and more severe negative supply shocks. Is that your view? More broadly, how is the RBA considering how it addresses climate change from a monetary policy point of view?

Mr Lowe: I agree with Mr McKibbin's observation that we are going to see more supply shocks because of climate and we will have to factor that into our decision-making. We are spending a lot of time on climate related issues because they affect not just the economy but also the financial system. Energy transition is a huge opportunity for Australia and could reshape our exports. Coal exports over time will go to zero, and gas over time will be depleted as well, but we have a huge opportunities there. Thinking about the prospects for the country over the next 20 or 30 years, the investments we make in renewable energy are incredibly important. They don't affect monetary policy decisions from month to month but over the next 20 years they are going to be incredibly important—affecting the investment outlook, where the jobs will be, and the prices we pay for a whole bunch of goods and services. They're really important framing issues for our decisions. Obviously, they're not going to affect whether we change interest rates by 25 or 50 basis points next month, but they're really important framing issues.

The other set of issues that we are working very closely on are related to the financial sector—I chair the Council of Financial Regulators. There are two major pieces of work going on there. The first is the climate risk vulnerability assessment, so asking the banks to do these exercises to see how well they're prepared and managing climate risks. The other, which is work that really ASIC is leading, is disclosure because the allocation of capital is critically important to solving many of these risks. For the capital markets to work well, people need information. They need to understand what your risks are, how you manage them and what the opportunities are. There's a global effort here to improve the quality, comprehensiveness and consistency of disclosure. ASIC is leading that work. We spend a lot of time on it, through the Council of Financial Regulators, and I think that's really important.

Capital markets will help us seize the opportunity we have as a country here, but we need the capital markets to have the information to make the right decisions. So it's not just government; it's putting in place the right policy framework, it's the disclosure environment guiding the allocation of capital. We're also involved with a group called the Network for Greening the Financial System, where the central banks around the world come together to look at these issues in a global context, so we're spending quite a lot of time with that group as well.

Ms SPENDER: I want to get to another very difficult issue, which is housing and housing affordability. Obviously one of the biggest impacts of the increase in interest rates is falling on households when housing affordability, by global measures, is extremely low in this country anyway. I'm interested in your perspective on how important increasing housing supply in the long term is to supporting greater financial stability and affordability in the economy as well as enabling households to better weather changing monetary policy.

Mr Lowe: It's a good point, and we've discussed this at previous versions of this committee. Interest rates get the blame for movements in housing prices, and I understand that the decisions that we take drive a lot of the cycle in housing prices. That's why housing prices are falling now, because we're raising interest rates, so a lot of the cyclical variation comes from the Reserve Bank.

But the fact that Australians have to pay higher prices for housing isn't anything to do with the Reserve Bank over the long period of time. It's the choices that we've made as a society that have given us high housing prices. The high housing prices come not from the high cost of construction; they come from the high cost of land embedded in each of our dwellings.

So why do we have a high cost of land embedded in our dwellings? It's because of the choices we've made: the choices we've made about taxation; the choices we've made about zoning and urban design; the fact that most of us have chosen to live in fantastic cities on the coast; the fact that, when we choose to live in these fantastic cities on the coast, we want a block of land, we don't want to live in high density; and we've chosen, as a society, to underinvest in transport. All those things have either reduced the supply of well-located land or increased the demand for well-located land, so we have high land prices embedded, which give us high housing prices.

Interest rates influence the cycle, but not structurally. We've seen in countries—parts of the US are a good example—where interest rates have been lower than they were here, but housing prices are much lower because, as a society, they've made different choices about where they live, investment in transport and taxation. It's the choices we've made as a people that have given us high housing prices, even though the interest rate influences the cycle. The central bank can't do anything about that. As an individual, not as the central bank, I think it would be better if we'd make different choices to give a lower average level of housing prices that would give people more opportunity and people would need to borrow less. The other choice we've made as a society is to make mortgage finance freely available. The great, dynamic, competitive financial sector is happy to provide mortgage finance. So everything we have done—if you ask what choices a society could make to give high housing prices, we have made them all. Not to say it's good or bad, but that's what we've done.

Ms SPENDER: One of the RBA's mandates is to deliver full employment. With the current rate of unemployment, I think this perspective of what NAIRU actually is, effectively, is much more debated than in the past. I would love to understand, from your point of view, how you are starting to think about NAIRU, the non-accelerating inflation rate of unemployment, and how you start to evaluate your future models in relation to that now.

Mr Lowe: It's a good question. It's a hard one as well. Not so long ago, people were saying if we got the employment rate in Australia down to five, that would be a great outcome. I had been hopeful that we could do better than that; I was hopeful we could get it down to four. I thought if we could get the unemployment rate to four, that would be a fantastic outcome. Here we are at 3½. I am doubtful whether we can sustain 3½ because the feedback we're getting from business through the liaison program is that at 3½ per cent unemployment it's way too hard to find workers. But you never know. Luci, have your staff been doing modelling?

Dr Ellis: Yes, we have. I think one of the challenges—the governor is absolutely right; we have been thinking something in the low fours. I think I said at the last meeting of the previous version of this committee, something in the high threes to low fours was our best assessment then, and we used something at the upper end of that range as the notional NAIRU in the most recent round of forecasts.

Unfortunately, the standard academic models of how to estimate the NAIRU—because you do have to infer it from data; it's not there to be seen directly—look at the pandemic period and they tell you that the NAIRU was going up at that moment. I don't believe that for a minute. I do not think that the actual evidence on wages growth tells you that the NAIRU is back above five. These models look at inflation and wages growth and unemployment all together. So there is also an assumption because you also have to infer inflation expectations from the various partial indicators of that. Those standard models are very much on the assumption that everything is driven by demand; they don't deal with supply shocks and they've certainly never seen a lockdown before, so those models would spit out a much higher number. So one of the active pieces of work that the team are working on is how to actually manage a NAIRU estimate when there has been a pandemic and you've had these big supply shocks. We have just had to apply some better judgement in the most recent forecast rounds, but I think it's an active area of research.

Ms SPENDER: I will come to my final question; I think I am almost out of time. It's more about the lags. You mentioned in your opening remarks that one of the issues we face is the lags to the impact of the rate rises, particularly in relation to people who have fixed-rate mortgages. How do you account for the potential lags in feeling these changes, and what are some of the lessons we can learn from the past in terms of how those lags have played out that we should bear right now?

Mr Lowe: The evidence we have from the past is that when we change interest rates the maximum effect on economic activity is roughly 18 months to two years afterwards, and then it takes a while for that to feed through to inflation. So there is a two-year lag before we see the maximum effect of that. That's understandable, because when you think about the transmission mechanisms of monetary policy, one is the exchange rate, so the exchange rate changes, and then it takes time for firms to change their investment and sourcing decisions. Another is through changes in the housing prices, which we talked about before. That affects spending, but it takes time for people to do that, and then once people change their spending, it takes time for firms to adjust their investment plans. So by the time you go through all these layers—they're quite long effects, and we are very conscious of that. This is one of the reasons we have to forecast.

During the early stages of the pandemic we said we were going to base our monetary policy on actual inflation because we'd had a period where we were undershooting the inflation target and our forecasts had not been that good, and we had to focus very much on actual outcomes. Now that actual outcomes have moved so much, we're moving back into a world where we've got to rely more on our forecasts. In forecasting we factor in these 18-month to two-year lags.

The other consideration in setting policy is not just understanding the lags but thinking about the level of interest rates. That is in response to Andrew's question before—is the level of interest rates roughly expansionary or contractionary or neutral? Put together, the assessment level—it's getting close to normal and probably still a bit low. And the lags—it's difficult because the lags change through time as well. We know that households have built up all these buffers. Some people argue it allows households to smooth through interest rate increases in a way they mightn't have done in the past. In the last two years, in aggregate, households saved an extra $250 billion over and above what they normally would have in a two-year period. That's a lot of money, and it's not evenly distributed. So that's another thing we're factoring in: how are people going to use that extra $250 billion? Are they going to let it sit there and be part of their accumulated wealth or are they going to draw down these buffers? This is why there's so much uncertainty at the moment, because there are a lot of moving pieces. It's pretty tough.

Ms SPENDER: Thank you.

Ms LAWRENCE: I've heard very clearly that you have the will and the resolve to restore price stability. Do you feel you have the tools to do so?

Mr Lowe: We have the tools. Interest rates are a blunt tool but a powerful one. I hope we don't have to use it too much. But I think we have the tool to get inflation back down again, and we will use that tool to the extent we need to.

Ms LAWRENCE: Leading a little further from the questions Ms Spender asked you, around that cumulative impact of the interest rate rises you have done already: what sort of analysis are you doing in case there is a more severe response from consumers than expected?

Mr Lowe: You mean people cutting back spending a lot? If that were to happen, the profile of interest rates is obviously lower. One of the critical factors driving the economy is consumer spending. At the moment the card data and payments data we have and the retail data from our liaison all suggest that people are continuing to spend. Many people are downgrading—maybe they're going for a cheaper cut of meat or something—but they're still spending. If it turns out that the big decline in consumer sentiment ends up weighing on spending by more than we think, that will have implications for the path of interest rates.

Ms LAWRENCE: Is that the main indicator you're using to track consumer impact—around their credit card usage and their discretionary and nondiscretionary spending?

Mr Lowe: As Luci talked about before, one of the benefits of improvements in data collection is that we've got access to a lot more data on card spending and retail sales. We talk to the retailers all the time. We track mobility at shopping centres. We've got a whole bunch of things we can now look at that we wouldn't have been able to look at in previous years. I feel like we've now got a better read on what's going on at any given point in time than we used to.

Ms LAWRENCE: Back in February you talked about the need to be patient. Now we've seen five successive rate rises, and you've said quite assertively that there will be further ones. How are you allowing time, though, to assess that cumulative impact?

Mr Lowe: In February, on underlying inflation, we got to the midpoint of the inflation band for the first time in seven years. We'd had underlying inflation below the midpoint of the target band for seven years. In February, inflation was still pretty low. As I said in the introductory remarks, a lot has changed since then, hasn't it? The inflation dynamics have moved a lot, and some of them seem pretty persistent. Others will fall away. We're just having to factor in the things that will fall away. Lower commodity prices and the improvements in global supply chains will help, but—

Ms LAWRENCE: You spoke—and I think Luci did too—about applying extreme vigour in your analysis, accepting that consumer confidence is weak but that people are still spending, but how long this will last for you don't know. And yet in the next breath you talk about how you will increase rates; the question is by how much. Why isn't taking no action a consideration, until you have had time to assess the impact of the lags of the five rate rises you've imposed already?

Mr Lowe: We've been talking about the consumer side. On the business side, business confidence is above average. When you ask businesses, 'How are things at the moment?' they're saying, 'Very, very good,' and they're hiring people at record rates. So it's not just a tale of negativity on the consumer side. On the business side of the economy, business is saying, at least in aggregate, 'Things are very good.' In fact, many of them are saying that they're too hot, because they can't get the workers. It is an unusual situation, where businesspeople tell us, 'We don't really want more customers at the moment.'

Ms LAWRENCE: But, in a global context, where everybody is taking the same action of raising rates, is taking no action not a strategy in itself? If it is, have you given consideration to that?

Mr Lowe: Yes, we have, but it's a risk management exercise, isn't it? If we took no action, and interest rates didn't go any further, or we hadn't moved last month, there would be a high probability that the community would think that we're not serious about getting inflation under control, that inflation expectations would adjust, that people would think, 'The Reserve Bank isn't really serious about this, so I'd better factor higher inflation into my ongoing decision-making.'

Ms LAWRENCE: But what about all the other factors that the households are looking at, such as the subsidy coming off the fuel price at the end of the month, for example? Obviously that'll have a flow-through impact. There is the higher level of household debt ratio that people are experiencing. In my seat of Hasluck, for example, I have 55 per cent mortgage holders—young families starting out—and 18 per cent renters. So 70 per cent of my electorate are directly impacted by the actions that the RBA take, but in the context of direct action that's happening elsewhere in the economy. I appreciate you're talking about how a lot of mortgage holders have buffers and so on, but I think the CBA is suggesting that 36 per cent actually don't and that, if you do enact further rate rises between now and Christmas, the numbers are quite extraordinary—it could be an increase of 40 per cent in repayments for some third of mortgage holders, which is an awful lot in my electorate. It could be an increase of 40 per cent in their repayments by the end of the year. In that climate, where they're already quite pinched but there are other levers being pulled perhaps in the fiscal policy, how is it that, this time around, you can't consider waiting and being patient, as you were in February, to see the impact of those five rate rises?

Mr Lowe: The main difference with February is inflation. In February, underlying—

Ms LAWRENCE: But just take the petrol price subsidy being removed in September. What will be the impact of that? I think it will potentially raise the price of goods and whatnot, which will potentially have the same impact of dampening consumer demand. If you take no action, what impact will that have on the currency, potentially making imports more expensive? That might have a dampening effect, again, on consumer demand. If that's the outcome you're looking for, are there not other ways to achieve that given you've already taken five steps to date?

Mr Lowe: Well, we don't have any other tools. I mean, I know—

Ms LAWRENCE: But you do. To do nothing is also a tool.

Mr Lowe: Well, it's a risk management exercise. If we were to do nothing, and inflation expectations were to adjust higher, and inflation were to persist at the higher rates, then that's going to be very bad for the people in your electorate.

Ms LAWRENCE: It is already bad.

Mr Lowe: So it's a trade-off—

Ms LAWRENCE: It will likely get worse by Christmas.

Mr Lowe: It will get more difficult, but it will be more difficult still if inflation gets entrenched higher. Then we will have to have much, much higher interest rates to get it back down, because we can't have a world where inflation just stays high, because we know—

Ms LAWRENCE: But you seem to sometimes come back to looking at things in a vacuum, without looking at all the other factors that are at play. You've spoken about the supply chain and the disruptions there easing, which will, hopefully, lower prices. We've talked about the government having different policies, be those around improving housing stocks and supply. You've talked about housing prices coming down. So it's all these other factors—commodity prices are lowering. You've talked about all these other factors, but then you still seem to come back to this—and this is not to say you're wrong. I'm just asking because I don't understand the logic yet of why you're quite adamant that there has to be a rate rise as opposed to considering that the cumulative impact of the rate rises hasn't yet landed, and we know that household debt ratio is at its highest. So how are you layering all of these different elements to still arrive at that: we must raise rates? Why isn't it that we 'may' make rate rises something that you're speaking about instead?

Mr Lowe: Yes. We've done our best to take into account all the factors that you're talking about. We know there are lags and we know that people are hurting. We also know that businesses are hiring people at record rates, that businesses want to invest and that there's quite a lot of forward momentum in the business sector. When we do our forecasts we do our best to take all those various things into account. And when we put a further increase in interest rates into the forecasts, we still have inflation next year at four and a bit. It's not until late 2024, so more than two years away, that inflation is back to three per cent.

So even with further increases in interest rates and the pain that many people are experiencing, we still think inflation is going to be above three per cent in two years time. And the longer it stays above three per cent the more difficult it is going to become, because expectations are—and we had the conversation with Andrew—if that happens, that then we have higher interest rates and a recession, which is damaging. So we've got two difficult positions at the moment. There's some pain now and, hopefully, real wages start rising again next year, against the risk of not doing anything, just sitting on our hands and having inflation stay higher and very—

Ms LAWRENCE: I don't think anyone is sitting on their hands, and that's my point. I think there are a lot of other elements—

Mr Lowe: Yes.

Ms LAWRENCE: It wouldn't be a case of sitting on your hands. I'm not suggesting that that's how the perception or the experience would be.

Mr Lowe: Yes.

Ms LAWRENCE: You talked about wage growth. I appreciate that wonderful place of full employment, but we heard this week that some 900,000 people are actually having to take a second job because perhaps the wages that they're receiving are just insufficient to be able to make ends meet. That's obviously going to be amplified by your intention to increase interest rates. Previously you've stated that you feel 3½ per cent wage growth is sustainable. I just would like to see how you feel about that in the context of the pressure and the constraints that people are already experiencing without that impact of the interest rate rises fully landing in households yet.

Mr Lowe: Yes. I've said previously that I thought 3½ per cent was a reasonable anchor point for thinking about what types of wage increases our economy can deliver over the medium term. That was on the basis that expected to deliver 2½ per cent inflation and labour productivity growth of, let's say, one per cent, and that workers should get their share of that. So 2½ plus one would give 3½ per cent growth in a broad measure of wages. I think that's a reasonable anchor point. If productivity growth were slower than that then 3½ per cent would be too high. If productivity growth were stronger than that, as it was in the 1990s, because businesses and government instituted reform, then we can do better than that. So it really comes down to productivity growth.

In the short run inflation is higher, isn't it? I also talked about this before, that it's very difficult for people to experience declines in their real wages this year. I know it's really hard for people, particularly when interest rates are rising. So there's a natural tendency to say, 'Well, we shouldn't allow that to happen,' that wages should go up faster to compensate people for the inflation. I can understand why people think that; at some level it makes sense, doesn't it? But if you accept that proposition and wages grow by six per cent to compensate people for inflation, where do you think inflation will be next year? It will still be high and we'll need to say to people, 'You'll get compensation for that because we don't want you to suffer a decline in your real wages,' and then the following year inflation is high and that would have to be responded to with much higher interest rates. While it's difficult, and it's very hard for people to experience a decline in real wages this year, the alternative, sadly, is much more difficult.

Ms LAWRENCE: I have a final question, on a completely different note. As you're right to do, on 19 July 2021 and again on 27 January 2022 you met with the then Treasurer, Josh Frydenberg. I note that the Prime Minister, Scott Morrison, was also in attendance. Were you made aware of the fact that the RBA had two Treasurers for the period from May last year to May this year? Was this dual arrangement ever reported to you as the governor?

Mr Lowe: No, it was not. I was as surprised as the rest of the community.

Ms LAWRENCE: Thank you.

Mr VAN MANEN: I've been listening with a great deal of interest to a variety of the questions from colleagues and to your responses, Mr Lowe. Following on from Ms Lawrence's line of questioning around the impacts on families, I suspect her electorate is very much like mine. These interest rate rises impact the middle-to-lower socioeconomic parts of my community at a much greater rate, directly through mortgage costs or rental increases in addition to increasing grocery prices, increasing electricity prices, increasing fuel prices et cetera. Can you please explain to me, because I haven't heard your response in any of the questions, how increasing interest rates is possibly going to impact and reduce any of these cost-of-living measures which are in part reflecting in the inflation rate.

Mr Lowe: Inflation is higher for two reasons. One is the global story, and we can't really do anything about that. But the other reason, and I talked about this in the introductory comments, is the domestic situation. Domestic demand is very, very strong, and the economy is having trouble meeting that demand. That's the reality we face. Many businesses have said they cannot meet the demand. Demand in the economy is very, very strong, and when demand is strong relative to supply, prices go up. So there's costs—

Mr VAN MANEN: With the greatest respect, Mr Lowe, I understand the causes of inflation. That's no mystery to me and probably to most others. But isn't that the counterpoint to the argument to raise interest rates? Many of those factors are temporary. We've had disaster related impacts on the cost of groceries, if you want to talk about a $10 or $12 lettuce. We've had global factors impacting fuel prices and also energy prices. Most of my people here in Queensland, certainly, have had a 15 per cent increase in their electricity prices from 1 July, which is yet to flow through fully. Increasing interest rates on top of that is not going to change those factors in the least. It's not going to reduce electricity prices. It's not going to reduce the impact of fuel prices. It's not going to reduce the cost of groceries. That will resolve itself as our farmers get back into full production following the floods. Then, in addition, your adding interest rate increases on top of that. I don't see the sense in doubling up on those cost-of-living pressures for many of the people in my communities who are already struggling to make ends meet.

Mr Lowe: The higher interest rates slow growth in aggregate demand—that's true—and when there's slower growth in aggregate demand there will be less upward pressure on both wages and prices. Firms will have to do more discounting and inflation pressures are less. I accept that it's not going to affect the price of electricity and the price of a lettuce, but higher interest rates, to the extent they affect aggregate demand—and what I'm hearing here very clearly is that it is affecting aggregate demand, because it really impacts people. And when we have lower growth in aggregate demand we'll get a better balance of supply and demand in the economy, and that will mean less upward pressure on inflation. If inflation—

Mr VAN MANEN: You're going to get less upward pressure on inflation as supply chains normalise. After having a discussion with some of my builders earlier this week, one of my concerns is that—and touching on some of your earlier comments about pricing—many of them have faced significant price increases on their inputs to building houses. They're saying those price increases are moderating or flattening out but the prices aren't coming down. That, to me, is a huge concern, in that we are potentially facing a situation where our cost base in our economy is now permanently higher. It's actually not going to come back down. One of their big inputs, they said to me, is the cost of transport.

Mr Lowe: Yes. And that's partly the higher cost of fuel, but it has also been partly the very strong demands on the transport system relative to the ability of the system to provide trucks and rail. In many parts of the economy the balance between demand and supply has moved to a point where it's putting upward pressure on prices, and higher interest rates will help recalibrate that—not in every sector, but in enough sectors. The combination of the various factors you were talking about, the improvements in the supply chain and maybe improvements in the agricultural sector, and higher interest rates, together, I think, will bring inflation back down. This is why I am more confident than many of my peers in other central banks that Australia can navigate this narrow path to bring inflation back down without the economy slowing too much. We've got enough things going on on supply side, and wages growth has not picked up too much here—

Mr VAN MANEN: Sorry. Can I ask a follow on question from that?

Mr Lowe: Yes, go ahead.

Mr VAN MANEN: In relation to your assessment of the rate of inflation, we often see the headline rate of inflation reported, which I think in your August monetary statement was 6.1 per cent. But the trimmed mean average was about 4.9, from memory, in your August report. What is the figure that you use to make a decision on what the interest rate increases should or should not be? Is it that headline number or is it a different figure based on trying to filter out these external shocks—some of which might be one-off or might carry through for a little bit longer but be shorter term in nature than a long-term structural change?

Mr Lowe: Not surprisingly, we look at all the measures. The headline measure is important because it influences people's expectations of what inflation is going to be in the future. It's kind of the thing that gets the most media coverage. But the measures of underlying inflation are critically important, because they give us a sense of what the ongoing momentum is. If the price of oil is going up very quickly and the price of homebuilding is going up very quickly, but other things in the economy are not rising in price as quickly, that's quite important. The trimmed mean trims out the price movements at the 15 per cent. We rate all the price changes in the economy and we chop off the tails at the 15th percentile, both the bottom tail and the upper tail, and look at the inflation rate in the remaining items.

The other measure we use is to look at the median. We get the distribution of price changes and take out the middle of the distribution. We're looking at all these measures, because want to understand what the ongoing inflation momentum in the economy is, and, at the moment, it's too high. It's considerably too high, and that's partly because demand is strong relative to supply. Higher interest rates are part of the way we get that balance back. I know it hurts people, but it's going to hurt people more if we don't get the balance back.

Mr VAN MANEN: I'll ask another question in relation to that. What other tools do you have, as the RBA, in your kitbag, other than interest rates, to lower the rate of inflation? You mentioned in response to an earlier question—it might have been in your opening remarks—that you chair the Council of Financial Regulators. What discussions would you have with the likes of APRA about lending standards and access to finance as alternative tools to manage demand rather than the very blunt instrument of interest rates?

Mr Lowe: The Reserve Bank just has interest rates, except for in extreme circumstances. During the pandemic we had other monetary policy tools, but they're not useful at the moment. I don't think it would make sense to try and control growth in the economy at the moment by tightening up lending standards. That would be, at least in principle, another possibility, wouldn't it, to say, 'We need growth and demand to be slower, so we're going to make it harder for businesses to get credit.' I don't think that makes sense.

The use of these credit related tools was very important in the years when borrowing was growing very, very quickly, particularly in the household sector. For some years I had been concerned that growth in household income was maybe five per cent and growth in debt was 10 per cent. For one or two years that's probably okay, but it's a dangerous situation, given the higher level of debt, for growth in debt to be double what it was in income, and that was the situation we were facing. When that was the situation and credit standards were deteriorating, we worked with APRA to make it a bit more difficult for people to get mortgages. They have to hold bigger buffers. That was the context in which APRA was using those tools. I don't think it makes sense to use them to slow the growth in the economy. We want businesses to be able to get access to credit so they can expand and invest, and the demand for housing finance is moderating anyhow.

Mr VAN MANEN: I don't have an issue with business having access to capital, but doesn't increasing interest rates make access to capital more difficult, from a servicing perspective anyway? It's just a different way of dealing with the same issue. I would argue that we have over-reliance on housing investment and finance in this country, at the expense of business on many occasions. That's a separate discussion we can have at another time. We are facing an increase in the fuel excise back to its full rate at the end of September, and I've seen some commentary that indicates that that may add a quarter of a per cent to the inflation rate of the next measure. How will the Reserve Bank take that into account when considering future interest rate increases, given that potential impact on the inflation rate?

Mr Lowe: In and of itself it has no effect on monetary policy. By the time we go into next year, looking at the forecasts, that increase will have dropped out. We're expecting inflation next year to be 4¼ and the following year to be three. The increase in the excise rate at the moment isn't going to affect the annual inflation rate next year or in 2024. We're really looking through that. I can certainly understand why the government is committed to reinstituting the previous rate of tax, because we do face medium-term fiscal issues. We need to address that. But it's not going to affect monetary policy at all.

Mr VAN MANEN: My final question is around employment. You've touched on it a couple of times today in response to other questions. Talking to local businesses over the past few weeks, one of the interesting things I keep getting feedback on—and where I agree with you—is that employers are looking for staff. One of the interesting pieces is that people aren't prepared to train staff or take on people on a work-experience or other basis in a short-term capacity to see whether they're fit for the job or whether they're interested in those roles. What, if any, discussions are you having with the business community? I remember, when I started in the bank 30- or 40-odd years ago, the amount of training businesses did at that time compared to what a lot of businesses do today. What discussions are you having with the business community about their willingness to take a step back and start to train their workforce rather than trying to find people who are already ready and fit to go?

Mr Lowe: I'm glad you raised this. I have a lot of discussions with businesspeople on this. They complain about the lack of skilled workers. They often say the government should do something about it. I say, 'Well, you should do something about it as well.' Like you, I recount my own experience. I joined the Reserve Bank from high school. It was in 1980. At the time, the Reserve Bank couldn't hire economists. We were considered an administrative arm of government. It wasn't a good place to be. It said to people like me who did economics in high school: 'Come and work for us, and go to university at night-time. If you do that, then we'll give you support to study and build up your skill base.' A number of my colleagues benefited from that. The Reserve Bank invested—it was a tight labour market; we couldn't hire economists—in building people.

That model went out, and now, like other organisations, we go to the market and hire fully trained economists from either Australia or overseas. As a society we've gone away from employers developing their own people, to hiring them in the market, sometimes the international market. I personally think that's a backwards step. We need to get, at least to some degree, back to that world—which, when I entered the labour market, was fairly tight—where firms have to invest in their own people more. When we weren't at full employment and we could easily hire people overseas, it was very easy to go to the market to hire the people you want, but we're not in that world anymore. I always encourage businesspeople to think about training again like they did when the labour market was tight previously.

Mr VAN MANEN: Thank you, Mr Lowe.

Mr LAXALE: Thank you, Governor, for your time today. You'd be aware of the term 'housing stress' or 'rental stress'. How does the RBA define housing stress?

Mr Lowe: I don't know that we've got a formal definition. Brad has recently taken over the financial stability area of the bank, so perhaps this is an opportunity. You're tracking various measures.

Dr Jones: There are a couple of ways to think about this through both the rental lens and the owner-occupier lens. There's no doubt that, on the rental side, households that are having to renew their leases are facing very material increases in rent, about a 12 per cent annual increase in new advertised rents. The total stock of rents across the economy is growing at a much slower pace. Only a small part of the rental market is turning over at any point in time.

Across the economy as a whole, rents as measured in the CPI are increasing at about a two per cent rate, but those who are facing resets are seeing very material increases. What we know about the roughly one-third of Australians who rent is that they tend to be lower-income households. Not only are those households facing much higher rents; the share of their consumption devoted to essentials is also relatively high. We know that inflation in that essential basket is increasing at a pretty solid clip. For low-income households, those who rent and those who are facing rent resets, there's no question that there are a growing number of households that are feeling real strain on their household budgets.

For owner-occupiers, the situation is much more nuanced. There's a quite significant cohort of borrowers who, so far, have not experienced much of an uplift, if any, in fact, in their loan repayments. In fact, we've done some analysis—and this will be forthcoming in the financial stability report in a few weeks: if we take the market implied path for interest rates and also our inflation forecasts, and put that all together, there's a very sizable cohort of households who are still going to have quite sizable spare cash flows. You've got about a third of borrowers who are actually quite well placed to accommodate an increase in cost of living and borrowing costs. There's also a cohort at the other end of that distribution who have quite high debt and very little in the way of pre-payment buffers—less than three months worth of excess mortgage payments. Those households—the high-debt, low-buffer households—tend to be the ones that are disproportionately populated by low-income households—so they have less ability to trim their expenditure. To give you a number, about six per cent of variable rate owner-occupiers are what we would classify as high-debt, low-buffer households; they're the ones where we're expecting their ability to accumulate spare cash flow to basically evaporate over the next couple of years. They will still have some margin of adjustment. Households in aggregate have built up a lot of savings but lower income households less so. There will be some ability to draw down on those savings. But there is certainly a tail of households in the rental market and even in the owner-occupier market that are going to find life more challenging in the next 12 to 18 months.

Mr LAXALE: Just on that definition: the ABS would define someone in housing or rental stress where over 30 per cent of the household's gross income is being used to pay. Is that the ballpark figure—is that what the RBA generally recognise?

Ms Bullock: That's the general figure we used.

Mr LAXALE: You've increased rates five months in a row. What consideration do you give to those experiencing housing stress when making these decisions?

Mr Lowe: These facts that Brad's reported will get discussed at the board; we'll have another extensive discussion of that next month. We're very cognisant of the fact that a lot of people are finding things very difficult at the moment. Rents are going up—new rents are going up quite quickly for people—and there are a large number of people who have high debt and low buffers. We know that that is very difficult for people.

Mr LAXALE: Dr Jones, you mentioned mortgage holders. When you're around the board table making the decision to raise rates, would you calculate a 25 basis point increase and say, 'That will take X amount out of the family budget'? Is that how these decisions are made? Do you weigh up 50 basis points, zero, 25, 75—is that how you get a figure?

Mr Lowe: We certainly look at what happens to interest payments relative to income when we increase interest rates by certain amounts. That's quite an important consideration—how big a buffer do people have and how many people are going to be impacted by the higher interest rates. We talk a lot about that.

I've said this before: it's very difficult for people, but—this is the point—it will be even more difficult if inflation stays high. If you've got a mortgage, you don't like higher interest rates—we understand that—and it hurts. But having inflation higher for a long period of time will mean higher interest rates and fewer jobs, and that will hurt a lot more. I know it's unpleasant for this year, but I ask people to look through this year. If we can manage this successfully then we can look forward next year, with: rising real wages again; Australians having jobs at rates they haven't had in many, many years and being able to get the hours they work; young kids having jobs; and female participation and participation by older Australians rising. I know this year is very difficult, particularly for people without buffers, but if we manage this well, as a country, we can look forward to prosperity again. We can put that at risk, though, if we say: 'Well, it's all too hard. We don't want to cause any pain for anyone.'

Mr LAXALE: I'd like to separate mortgage holders and renters, if that's okay. There's always a lot of analysis in the public domain of how rate rises impact mortgage holders. Figures always come out in news articles that say, 'On a million-dollar loan, you are paying an extra $288.' It is very simple analysis. I would imagine they would be the same figures you use that you just told us. How does the RBA measure the impact of rate rises on renters?

Mr Lowe: On rent, most of the time it doesn't have a direct impact on rent. Some landlords have recently been saying that higher interest rates are going to lead to higher rents because they have higher costs of financing and they are going to pass that through into rents in a tight rental market. Some say that. I don't think that is a first-order effect on inflation.

Mr LAXALE: You just had Mr Jones say we are seeing 12 per cent increases at a time when interest rates are on the increase. Are you saying they are not related?

Mr Lowe: If they are related, it is only very marginally. The rents are rising quickly, not because interest rates are going up but because the rental market is tight. Remember, during the pandemic many landlords did not put their rents up and some even gave rent holidays to people. That was part of the social contract that was constructed. Now that the pandemic is—let's hope—behind us, the rental market is tight and there is some catch up going on. It is difficult for people. It is not higher interest rates that are driving higher rent; it is the tightness in the rental market.

Ms Bullock: I might just add briefly there have been changes in household formation in this period. You might remember that in the pandemic in fact the vacancy rates for rent went up because people moved home, people lost jobs and share houses were disbanded. What we are observing now is a little bit of a switch in the way people want to live. If you are going to rent, you might rent with the smaller group of people. You might rent with one other person rather than share houses. So there is a supply demand thing going on here which goes the point Phil is making.

Mr LAXALE: Sure but there is supply and demand for mortgage holders as well. I will read a quote from an article from 9News, which has a pretty aggressive title: 'Australia is facing a $158 billion mortgage time bomb'. This is from 13 September by Nick Pearson. He has analysis here that says:

> Since May—when the cash rate was a now long-forgotten 0.1 per cent—that represents an increase of more than $600 a month for those with $500,000 loans and an eye-watering five-month increase of more than $1,200 for those with more than a million dollars owing on their mortgage.

Again, I ask the governor: What is the impact of a 225 basis point increase on renters?

Mr Lowe: It is not particularly large. There will be some flow-through to some renters because some landlords will put their rents up because of higher interest rates but it is not a first-order effect.

Mr LAXALE: In my electorate of Bennelong, 40 per cent of tenancies are renters. Nearby in Parramatta where Dr Charlton is it is 45 per cent. In New South Wales, renting has overtaken mortgage owners for the first time in the 10 years I have looked back. Are you saying that these interest rate rises have had little impact on 40 per cent of those in my electorate on their ability—

Mr Lowe: I mean, for some people obviously it has had an impact but the fact that people are paying higher rents at the moment is not because of higher interest rates; it is because of these structural factors. People want more floor space when they are working from home, so the demand for floor space has increased and that puts pressure in the market. That is the primary thing that is going on here. The additional supply of new apartments in the last year or two has been fairly small and the demand for apartment floor space is rising again because people work from home. So that is the thing that is going on.

If we want to address high rental costs, the solution isn't interest rates; it is more supply, changing planning arrangements and probably even on tax as well. I know interest rates get blamed for lots of things but I don't think they should be blamed for higher rents for most people.

Dr Jones: To give some substance to that point, we have looked very closely empirically at the first-order drivers of rents, and the two variables that jump out there are incomes and the vacancy rate. Household incomes have been growing strongly, and the vacancy rate nationally is low—below one per cent, which is about as low as we've seen, and in some parts of regional Australia it's even lower. When you have rising incomes and a vacancy rate below one per cent, the inevitable outcome is going to be new advertised rents increasing at a very solid rate, and that's what we've been observing.

Mr LAXALE: You said in a previous answer that you give great consideration—I'm paraphrasing here—to increased mortgage repayments. From what I am hearing, you don't give that much consideration to the same thing, but for renters. Is that a fair assessment?

Mr Lowe: No. We spend a lot of time trying to understand the pressure on household budgets, and rents, for many people, is a very significant share of their budget. So when we are understanding the pressures on household finances we pay a lot of attention to rentals. That's why Brad had these figures on…

Mr LAXALE: You've got a dollar figure for a mortgage increase. Where's the analysis for rents? I don't understand why—

Mr Lowe: We're going back to the same point. I don't think there is much of a link between when we increase rates by 50 basis points and what people pay in rents tomorrow. Many rental contracts are for one year, so the flow through is slow, and many landlords don't put up their rentals just because interest rates are going up. I'm not denying that interest rates are an influence on rents; I just don't think they are a first order influence for most rentals.

Mr LAXALE: It was reported yesterday in the *Sydney Morning Herald* that, of the current non-executive board members appointed by the former Treasurer, Josh Frydenberg, or by his predecessor, Scott Morrison, 'only one is a trained economist'. In your personal and professional view, do you believe that is appropriate?

Mr Lowe: I would question the facts as reported there. I'm a trained economist, Michele is—

Mr LAXALE: No, out of the non-executive board members.

Mr Lowe: Steven Kennedy, the Treasury secretary, is a trained economist. Professor Ian Harper is obviously a trained economist. So we already have four. Carolyn Hewson has very extensive experience in banking, finance and economics. Mark Barnaba has training in economics as well. So I would push back on the fact that the board doesn't have economic training. It doesn't have many professors of economics, if that's the point, but you don't need to be a professor of economics to understand economics and monetary policy. It helps, but you don't need those qualifications.

Mr WOLAHAN: After the jobs summit, the government flagged an increase in migration to 195,000 per annum. I have a four part question: have you modelled that; what is the impact on employment or unemployment; what is the impact on inflation; and, finally, what is the impact on rent and house prices?

Mr Lowe: Good questions. Perhaps I can share my perspectives here. I think opening the borders again and having immigration resume is incredibly important for the country's longer run prospects. This is about immigration. Australia has benefited hugely from immigration. Almost 50 per cent of the population were born overseas or have one parent who was born overseas. It's brought a dynamism to our country that very few other Western countries have. So I think it's one of our key national assets. That's how I think about immigration. It is the long-term benefits we get from it rather than the short-term.

But, in the short term, from my perspective, the focus needs to be on getting people with skills that are in short supply. I hear many businesses say they want to expand and they want to invest, but they can't get the people to do the expansion and the investment. That's creating bottlenecks in the economy. If we can blast through those bottlenecks with more people, we will have higher output and higher income. So we need to focus on skills.

I'm not sure that higher immigration has much effect on the unemployment rate. If you think about it from the perspective of an individual business, it's pretty clear. You can't undertake investment and you can't hire a worker, so you get a worker from overseas and things look better for you, and the labour market constraints ease. But when that worker has finished working for you they go home. They've got to live somewhere. They've got to eat. They go to the doctor. They go out and entertain themselves. Maybe their children need to get educated. And when they do all those things, that creates additional demand for labour. So the worker comes in and supplies more labour for the firm, but when they go home they create extra demand for labour in the economy. At an aggregate level, I don't think immigration really is going to have that much of an effect on the overall dynamics in the labour market or the unemployment rate. But it's incredibly important in delivering skills to people for businesses and for the longer run prospects for the country. I don't think it really has much effect on inflation or unemployment in the short run, other than the extent it can ease the supply bottlenecks because you get people with the right skills.

Mr WOLAHAN: Thank you. I want to take you to an answer you gave Ms Spender about housing affordability. You downplayed the role of interest rates. I'm sorry if I verbal you but I wrote down that you said, 'It isn't anything to do with Reserve Bank or interest rates.' I apologise if I've got that wrong.

Mr Lowe: I said the fact we've got structurally high housing prices wasn't anything to do with the Reserve Bank. It's the full responsibility for the cycle around the higher level.

Mr WOLAHAN: There's a 2019 RBA discussion paper written by Trent Saunders and Peter Tulip. It's titled 'A model of the Australian housing market'. In the abstract it says:

> We find that low interest rates … explain much of the rapid growth in housing prices and construction over the past few years.

How do you reconcile that abstract with the evidence you've given us today?

Mr Lowe: Luci can come in here if it's helpful. They were talking about the decline in real interest rates, which isn't something the Reserve Bank—I mean, we're the ones that actually deliver the level of interest rates, but we're really responding to broader forces which have levered lower real interest rates in the global economy. When you have lower real interest rates, all asset prices go up. That's what I think they are referring to.

Dr Ellis: Yes.

Mr Lowe: The lower real rates are coming from global developments. Again, while we get the blame for that, we're just the institution that's delivering the lower nominal interest rates because of what's happened around the globe.

Dr Ellis: I'll just expand on that. So there's the cyclical piece—that's the bit we are claiming responsibility for—and that's actually what they're talking about there. They're explaining how there was a cyclical increase in prices in that more recent period. But Phil's also right that there are two things going on in the long term as well.

One is that the decline in nominal and real interest rates over multiple decades, primarily in the nineties, did mean there was a level shift in the ratio of house prices to income. That doesn't actually change affordability—this is long-standing economics, back to Modigliani, and we've written about this many, many times—but, essentially, because inflation is lower and the equilibrium real interest rate is lower for global reasons that means you can service a bigger mortgage on the same repayment. In that sense housing affordability hasn't changed, but it maps into a higher price. So that was a one-off level shift.

That was mostly completed by 2004-05. What we've seen since then has been mostly cycling around a new higher level in relation to income. And, even more so, once you adjust for offset accounts—actually the household debt to income ratio has been pretty constant since about 2005. In that sense there was a level shift, which is explained by interest rates because nominal interest rates and real interest rates both came down; disinflation and deregulation, all of the downward forces on the neutral real interest rate, play into that. And, yes, the other component, the cyclical movement of interest rates, does have a large bearing on the cyclical movement of housing prices around the longer term trend.

Mr WOLAHAN: Governor, you've been quite frank today on the need for structural reforms, so thank you for that, particularly in terms of productivity. I'm interested in your views on the rates of home ownership, particularly for Australia's largest generation, often called millennials—those born between 1981 and 1996. How do you see us increasing the percentage of millennials owning homes?

Mr Lowe: How do I see us doing it? It's going to be pretty challenging. I think, for that to happen, it requires a lower level of housing price relative to people's income—for housing prices to grow more slowly than income for a while to make it more feasible for young people to buy housing. That comes back to the structural policies that I talked about before. It's urban design, the types of dwellings that we build, perhaps the tax arrangements, the transport system—because one reason we have a high value of land embedded in dwellings is that we've underinvested in transport, and transport can increase the supply of well-located land. That's what it does. And, if you increase the supply of well-located land, the value of land embedded in any particular dwelling will be lower. In previous committees I've talked about the best housing policy being a transport policy. It's tax, transport and urban design. I think, if we're really serious about lowering the cost of housing relative to income, they're the things we've got to tackle.

Interest rates—we raise them for a while, and housing prices come down so it's a bit more affordable, but it's not a sustainable solution because it's just cycling around this higher level.

The other dynamic that's playing out, as you would know, is the bank of mum and dad, where effectively houses get passed from generation to generation, which is fine if you can access the bank of mum and dad and your parents are going to pass the house or income through to you, but there are many Australians who aren't in a position to do that. Not as a central bank governor but as an Australian I worry a lot about that—that we're reinforcing, making worse, the existing distribution of wealth in society through the housing market.

So the inability to address zoning, taxation and transport has really, I think, negative effects, longer term effects, on society. That's not my day job, but thank you for giving me the opportunity to share that.

Mr WOLAHAN: I think that's becoming our day job! Further to Mr van Manen's question on APRA and inflation, I had a slightly different take on APRA. It's a narrower question. During the COVID-era interest rates, APRA required retail banks to include buffers for new mortgages, to ensure that unsustainable loans weren't issued. Those buffers now appear to be modest. Do you think they were sufficient, and do you think further upward revision is required for new loans?

Mr Lowe: Do you mind if I ask Michelle to answer that question?

Mr WOLAHAN: That's fine.

Mr Lowe: Because that was her area of the bank up until recently.

Ms Bullock: Yes, sure. You're talking about the mortgage serviceability buffer. The way APRA like the banks, or require the banks, to operate is to have a floor serviceability rate, if you like. When interest rates were really low, banks were effectively required to ask: could they still pay it back at a much higher interest rate? The buffer was 2.5 per cent; then APRA raised it to three per cent. Three is around what other countries have in terms of these sorts of serviceability buffers. What we're observing now of course, as interest rates rise, is that the serviceability buffer is on top of a higher interest rate. So I don't think there's a suggestion that we need an even higher buffer. I think the serviceability buffer is providing what's required. And it's worked in the past in the sense that, as we discussed earlier, even though interest rates have gone up, many households—not all households but many households—have found that they do have space because the space was built in in the first place.

Mr WOLAHAN: I just want to go to the role of fiscal and monetary policy, and this is to you, Governor. What would be the result of tightening monetary policy, as we're doing, but increasing fiscal expenditure? How do you think that would play out in terms of inflation?

Mr Lowe: Well, it would all depend upon the degree, wouldn't it? We're tightening monetary policy, but, if there was a very significant fiscal expansion now, that would put more pressure on aggregate demand, and the conversation we were having before was that stronger aggregate demand is putting upward pressure on prices. So that would mean higher interest rates. But it really talks about the degree—how much extra fiscal stimulus might or might not be given.

Mr WOLAHAN: Would they be pulling and pushing against each other?

Mr Lowe: Hypothetically, they could, couldn't they? But I don't want to speculate about what's in the budget. But there's a state of the world where fiscal developments are unhelpful for us. I'm not predicting that state of the world, but conceptually it's possible, isn't it? Let's hope we don't find ourselves in that state of the world. That isn't to say that there can't be some measures to alleviate the cost-of-living pressures that households are feeling within the budget envelope; but we're tightening interest rates, so it would be unhelpful to have fiscal expansion.

Mr WOLAHAN: We've seen globalisation get wound back for a variety of reasons, and globalisation and integration have been a deflationary force for some time. How do you see that playing out long term in terms of inflation?

Mr Lowe: Well, long-term inflation is determined by central banks. Our job will be easier or harder depending upon what's is going on in the broader economy. In the last 20 years globalisation and increased global supply from China made our jobs a bit easier. If that trend reverses and productivity growth is low, our job is going to be harder. So it's not just deglobalisation it's slower productivity growth and the demographics. Those things all mean slower growth in our real incomes, and our job of containing inflation is probably a bit harder. But, ultimately, the central banks determine the rate of inflation.

CHAIR: We'll hand over now to Ms Payne.

Ms PAYNE: Thank you, Governor, and each of you for your time today and the opportunity to ask you some questions. I want to go to the distributional impacts of the rate rises. Governor, you indicated in a speech on 8 September that there's an uneven effect across the economy and that the Reserve Bank spends a lot of time looking at disaggregated data to understand that. I was wondering if you could elaborate on that uneven impact on households and explain which data and how you analyse that.

Mr Lowe: I may ask Brad in a minute to touch on some of that, but just before I do can I make a more general point about income distribution? The best thing for people is to have a job. I know there's a lot of focus at the moment on the effect of higher interest rates on people, and I understand why that is, but a higher share of Australians have a job today than ever before. The female participation rate is the highest it has ever been, youth unemployment is the lowest in many, many decades and people are getting the hours of work they want. They might have to work two jobs, but they're getting the hours of work. So those are fantastic things for people's income and opportunity. And those things are the result of the monetary and fiscal response during the pandemic. I know we're looking at the other side of this as interest rates increase, but we shouldn't forget that from an income distribution perspective, and from the perspective of a welfare society, we're in a much, much better place than we've been for a long time.

Sorry, I think that's important contextual information! I understand that everyone is very concerned about higher interest rates now, but we should be welcoming and celebrating full employment. It's not you, but I don't hear enough people in our society celebrating and welcoming full employment. Sorry, Brad.

Dr Jones: On the data we're using: there's a whole range of metrics, and in fact Luci's team, a bit earlier this year, did a deep dive into income and wealth inequality in Australia. I'm not sure if Luci wants to speak to that in a moment. Maybe I can just give a few quick remarks about what has changed over the course of the pandemic in terms of the distribution, in particular, of savings.

As the governor mentioned a little earlier, the country has, in aggregate, accumulated actually a little north of $250 billion, but that accumulation of excess savings has not fallen evenly. The numbers that we monitor suggest that about 80 per cent of that extra $250 billion has gone to the top 40 per cent of households by income. That experience is not unusual by international standards when we look at the experience of the US, the UK and other places. Most of the run-up in excess savings during the pandemic went to higher-income households, in large part because their consumption of discretionary goods, ability to travel and those sorts of things were severely curtailed. It's a big aggregate increase in liquid savings, but most of it has gone to higher-income households. That's the first point.

On the wealth side, I'll just point out that the aggregate increase in household net wealth in the country since the pandemic has been about $3 trillion. It actually dwarfs the run-up in liquid savings that we've seen. Again, obviously, a fair chunk of that has gone to higher-income households.

I'll just make one point about how we see some of the stresses coming down the line from a disaggregated perspective. To your earlier point, yes, we look at the aggregates. We spend a lot of time on them, and we form policy on the basis of aggregates, but we are very, very attentive to how household finances are tracking at a disaggregated level.

When we do forward-looking scenario analysis, trying to get a handle on what sort of impact future interest-rate increases and increases in the cost of living could have out to the end of next year, what we find is that about 15 per cent of borrowers are going to have their spare cash flow fully taken up by the increase in borrowing costs and the increases in the cost of living. Other households will have other margins of adjustment. They may be able to curtail discretionary consumption a little or run down buffers, but about 15 per cent of borrowers are not going to have any spare saving each month if the market path for interest rates and our inflation profile are borne out.

At the other end of the spectrum, about one-third of borrowers, both fixed-rate and variable-rate borrowers, are not going to have any increase in their actual realised payments out to the end of next year. In the case of variable-rate borrowers, it's because they've been prepaying to such a degree that, even as interest rates go up, they're already servicing a mortgage at a rate that can fully absorb that increase in interest rates. So there is a very uneven impact coming at us from both rising interest rates and rising cost of living. Luci, do you want to give a bit more colour on the inequality side?

Dr Ellis: Sure. In terms of the various datasets that we have available, of course there's the HILDA survey, which we have 20 years of experience with. The ABS contributes quite a lot of useful information on this, including the household expenditure survey and the Survey of Income and Housing. We use surveys to get some colour on this. Some of the analysis that we've done on who ended up with the extra savings during the pandemic period was partly based on various commercial surveys that we have access to. So there are a range of different things.

The other point I'd make is about the liaison. In terms of how this is actually affecting people's experience, we talk to all the retailers every month, so if the retailers that are mainly targeted at lower-income earners are telling us a very different story to the ones who are perhaps more at the high end or in the middle market, that's telling us something. We also liaise with groups like the Financial Counselling Network and the debt collectors, and I can tell you the debt collectors were bored during the pandemic because there was just so much support. An awful lot of the government's support went to relatively low income earners, and there were a number of people, particularly young people, who were actually receiving more income during the lockdown periods than they were when they were working. These are all sources of information that we have.

Ms PAYNE: That's very interesting. You mentioned the retailers targeting low-income consumers tell a different story. What story are they—

Dr Ellis: If that were to happen—I'm not saying that that is what's happening. Obviously, I can't talk about specific liaison contacts, because it's all commercial-in-confidence. The fact is that we talk to some of the major retailers every month, and some of those have different target markets. So, if we were to hear the ones who mainly target lower-income spenders—this is a hypothetical—saying something very different from the ones who are high-end furnishings or much more discretionary, that would tell us something about where the impact of the various economic forces were lying. So we have a range of different information to triangulate, and that would be a very timely indicator.

Ms PAYNE: Thank you. I want to go now to climate disclosures. Obviously, the RBA have advocated for a clear climate disclosure policy. I'm interested to know how Australia compares internationally and how our current approach to climate disclosure impacts on the availability of capital for the transition to net zero.

Mr Lowe: There are standards being developed internationally which, it is intended, will sit alongside the international accounting standards. They'll be international climate sustainability standards, and Australia is going to need to find a way to implement those here. The government has a role to play there, and businesses also have a role to play. If we don't do that we'll fall behind what international investors expect. Regardless of whether you think this is a good or bad thing, the investors want it, and if we don't do it then they will be reluctant to invest in Australian businesses. So it's important that we keep pace with what's going on internationally. We are working through the Council of Financial Regulators and with the government to make sure that happens. It's a really important issue.

Ms PAYNE: Could you comment on the impact the government legislating out climate targets will have on that.

Mr Lowe: I don't know enough about the details, but the fact that Australia committed to net zero by 2050 was incredibly important. I've had a lot of discussions with overseas central banks and investors, and they were always asking about Australia's commitment. The fact that we had not signed up had people saying: 'Are you really serious about this? We want this. Do we want to invest in Australia?' It was a question mark that was always being raised, and that question mark isn't being raised in discussions we're having with investors at the moment. I'm not sure whether the legislating of it was critical, but the fact that we committed to it was important. Australia has great potential here with clean energy. We're now in a better position to sell that story and to execute it when we're seen to be on the same path that every one else was. When we were on a different path, people were saying, 'Are they really serious?' It was damaging us.

Ms PAYNE: I'll leave it there, Chair.

Mr HAMILTON: If we accept from the conversation today the RBA's view—highly summarised—you're not the big bad wolf. The series of rate rises we've seen isn't a result of some tumultuous bugger-up—highly summarised, I accept. What does good decision-making look like in the future? What are we looking for to give us the confidence that you discussed in your statement earlier. What does that look like?

Mr Lowe: What does—

Mr HAMILTON: Good decision-making.

Mr Lowe: I can tell you what a good outcome looks like: inflation gradually comes down and the unemployment rate sits not much different from four per cent and real wages start rising again.

Mr HAMILTON: We've seen the signals before that. It is in the decision-making space that I think is the crux of that confidence that we've discussed.

Mr Lowe: I'm struggling to come up with an answer, because I'm not quite sure what the question is. The Reserve Bank board meets each month and goes through all these considerations we've been talking about—the global situation, the pricing and wage dynamics in the economy, what's going on with households. We spend a lot of time, as we have at this hearing, talking about what's going on at the individual household level and how various parts of the community are being affected. Good decision-making I think looks like a continuation of that—putting these various factors together and trying to make what I would say are very difficult decisions that affect people unequally. We know we're making some people very unhappy, and we've got to keep in mind the prize at the end, and the prize is low and stable inflation, full employment and rising real wages. I think that prize is within grasp, but before we get it there is some pain, and it's difficult. I think good decision-making puts all that together and we deliberate on it and explain every single month.

CHAIR: Thank you all for appearing here today. The committee secretariat will be in touch with you in relation to any matters arising out of today's hearing. You will be sent a copy of the transcript of your evidence and will have an opportunity to request corrections to any transcription errors. I'd like to thank all of the witnesses and members for their time today, and I declare this hearing closed.

Committee adjourned at 12:29