Speech

Opening Statement to the House of Representatives Standing Committee on Economics

RESERVE BANK OF AUSTRALIA

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Good morning chair and members of the Committee.

These hearings are an important part of the accountability process for the Reserve Bank and my colleagues and I are pleased to be here to answer your questions.

I will start with a discussion of the inflation situation and the economic outlook. I will finish with an update on our priorities in the payments space and the cash distribution issues that the industry is dealing with.

Inflation

The Reserve Bank Board's mandate is to contribute to the welfare of the Australian people by delivering price stability and full employment. This mandate is set out in the *Reserve Bank Act 1959*. The *Statement on the Conduct of Monetary Policy*, agreed between the Australian Government and the Board, sets out how this works in practice. Specifically, we have agreed with the government that the best way of achieving low and stable inflation is to aim for annual consumer price inflation of between 2 and 3 per cent. While all outcomes within that range are consistent with our price stability objective, the Board sets policy to return inflation to the midpoint of the target. But the agreement with the government provides flexibility around the timeframe in which we meet our inflation objective. This is because we need to balance meeting our inflation objective with our full employment objective – achieving the maximum level of employment that is consistent with low and stable inflation.

The reason I set this out is to give context to the Board's current strategy for monetary policy. The Board is trying to bring inflation back to target in a reasonable timeframe while preserving as many of the gains in the labour market that we have seen in the past few years. This is the so-called narrow path.

So how are we doing? Since our previous appearance before this Committee, there has been further progress on inflation, but it has been very slow. Inflation peaked at 7.8 per cent in the December quarter 2022. It came down to 4.1 per cent at the end of 2023 but since then has only declined a further 0.3 percentage points to 3.8 per cent in the June quarter 2024. Underlying inflation, which abstracts from volatile components of the index, is also still elevated at 3.9 per cent in June 2024. This remains too high. Our current forecasts have underlying inflation by the end of this year still sitting around 3.5 per cent.

What is driving this persistent inflation? A lot of it reflects inflation in services. Most of the disinflation we have seen since the peak in December 2022 has been driven by a decline in goods price inflation. Through 2022, there was very high inflation in goods prices, reflecting supply chain issues at a time of strong aggregate demand. Prices of groceries and consumer durables and new dwelling construction costs all surged. Inflation in many of these goods has since eased substantially, except for new dwelling costs, which are still increasing by around 5 per cent on an annual basis. Inflation in services prices, on the other hand, has remained high, running at around 5 per cent. There has been broad-based inflation in market services, reflecting continued demand and the ability for some businesses to pass through costs. Other contributors to high inflation have been rents and insurance, reflecting conditions specific to those industries. All of this has meant that while goods price inflation has declined substantially, it has not been enough to offset continued high services price inflation.

This situation is not unique to Australia. Most advanced economies have experienced a similar pattern of inflation – a spike in inflation owing to goods and energy prices, followed by a sharp disinflation in goods prices but continued high services price inflation. As a result, other central banks are remaining cautious about the future path of interest rates. Some have decreased their policy rates a little but they have been emphasising that the job is still not done and policy remains restrictive.

Likewise here in Australia. We did not increase interest rates as much as some other central banks. And we have received some criticism for that. Indeed, some commentators continue to call for further tightening in monetary policy. But as I noted earlier, we have been trying to balance bringing inflation back down over a reasonable timeframe, without inflicting unnecessary damage on the labour market. And the Board's judgement to date has been that policy is currently sufficiently restrictive to do that.

The Board's recent decision

Which brings me to the Board's most recent decision. At its meeting on 5 and 6 August, the Board decided to leave the cash rate unchanged at 4.35 per cent. It recognised that while inflation had fallen substantially since its peak, it is still some way above the midpoint of the 2–3 per cent target range. And as I noted earlier, inflation is proving persistent. But the Board remains vigilant to upside risks to inflation and noted that policy will need to remain sufficiently restrictive until it is confident that inflation is moving sustainably towards the target range.

Prior to our decision, markets had brought forward their expectations of a rate cut following inflation outcomes in the United States and the June quarter CPI in Australia coming in a bit lower than expected. Then volatility in international financial markets resulted in further declines in interest rate expectations. Financial markets are still pricing in a rate cut by the end of the year. The Board's message, though, was that it is premature to be thinking about rate cuts. Inflation is still too high and, in underlying terms, is not expected to be back in the top of the band until the end of next year. Circumstances may change, of course, and the outlook is uncertain. But based on what the Board knows at present, it does not expect that it will be in a position to cut rates in the near term.

I understand that this is not what many households want to hear. Those with mortgages are feeling the squeeze on their cash flows from the increase in interest rates over the past couple of years. Businesses too are facing higher borrowing costs. But the alternative of higher inflation for longer is much worse. Inflation has not been this high for a few decades and I think many people have forgotten how bad it is – some younger people will not have experienced high inflation at all. There is a reason why there is so much talk about the cost of living – high inflation hurts everyone. It reduces what people can buy with their wages, erodes the value of savings, and it disproportionately hurts those on low or fixed incomes. This is why it is imperative that we do what we need to ensure inflation returns to levels at which it is in the background again.

Economic outlook

That said, the economic outlook remains highly uncertain. The RBA published its most recent forecasts at the same time as we announced the monetary policy decision. As I noted earlier, the central forecasts are for inflation to return to the target range late in 2025. It is forecast to approach the midpoint of the target band in 2026. This is a slightly slower return to target than we were forecasting in May. It reflects a judgement that the gap between aggregate demand and supply in the economy is larger than previously thought. That is, even though growth in the economy has been weak, the level of demand for goods and services is still higher than the ability of the economy to produce those goods and services.

These are our central forecasts and there is substantial uncertainty around them, more so the further out the forecasts are. Recognising this, we highlighted three key risks in the *Statement on Monetary Policy*: more excess demand in the economy at present than currently assessed; consumption growth in the future stronger or weaker than expected; and the labour market deteriorating by more than expected. The Statement provided some scenarios to demonstrate how different paths for the economy might affect the outcomes for inflation and employment. The scenarios show that if consumption or the labour market are weaker than expected, inflation could return to the target band more quickly and the unemployment rate could rise more sharply. And the reverse could occur if consumption and the labour market are stronger than expected. These scenarios are important because we know that economic activity and inflation could be much stronger or weaker than implied by our central forecasts. So we need to understand the implications for the economy and how monetary policy will have to respond if things turn out differently.

My colleague Andrew Hauser gave a considered speech on the issue of uncertainty on Monday. The key point was that we know the future is uncertain and that we therefore need to be humble in our forecasts, be willing to learn from our errors, and use a diverse range of models and qualitative intelligence, as well as internal and external challenge. And we need to respond as the economy evolves. The Board is conscious of this, hence its commitment to be driven by the data and to adjust its assessment as necessary. The Board is of the view that it currently has the balance right between reducing inflation in a reasonable timeframe and maintaining the gains in the labour market. Ultimately, our full employment goal is not served by letting inflation stay above target indefinitely. So the Board remains focused on the potential upside risks to inflation.

Before I finish, I want to say a few words on the payments system and issues in the cash distribution system.

Payments system

The Parliament is currently considering some important amendments to the *Payment Systems (Regulation) Act 1998* (PSRA) that will enable us to promote safety, efficiency and competition across all players in the payments ecosystem. Once the reforms are passed, we will undertake a comprehensive review of our retail payments regulation. This review will consider the appropriateness of our regulatory settings and principles, and how to apply them to emerging players and business models. Many stakeholders would like to see progress on a range of issues, including the high cost of card payments for small businesses, surcharging of consumers and competition issues related to mobile wallets. The timely passage of the PSRA reforms will allow us to consider these issues in the broader context of the RBA's expanded regulatory arrangements.

The Payments System Board discussed these issues at its quarterly meeting yesterday. It also discussed a number of other issues that are important for the future of the payments system in Australia. This included a paper that has been written jointly with the Australian Treasury, providing a stocktake and roadmap on domestic research priorities relating to the concept of central bank digital currency. The paper will be published in September. The Board also discussed developments in least-cost routing, challenges in wholesale cash distribution and opportunities relating to improved access and functionality for the New Payments Platform.

Banknote distribution

Another issue I would like to update the Committee on is recent developments in the cash distribution system. While the use of cash for everyday payments has declined in recent decades, it remains an important means of payment for many Australians. Cash is used as a store of wealth, particularly during periods of economic uncertainty, and can be a useful backup for electronic methods of payment.

As you know, the cash distribution system came under considerable stress earlier in the year when the financial viability of the largest firm providing cash-in-transit services, Linfox Armaguard, came under question. Since then, the RBA, the Australian Treasury and key participants in the cash distribution industry have been working together to strengthen business continuity arrangements, increasing the ability of the industry to respond to a significant disruption to the supply of cash. In late June, an industry support package of approximately $50 million over 12 months was agreed between Linfox Armaguard and its major banking and retail customers, reducing the near-term risk of a major disruption. The funding deal should provide time for the industry participants, the RBA and government to focus on formulating a longer term model for cash distribution, so that cash is available for those who need and want to use it. Developing a more durable future cash distribution system will require broad consultation and require participants in the system to approach these issues in the public interest.

Thank you for listening. My colleagues and I look forward to answering your questions.