Speech

Economic Conditions and the RBA's Transformation

RESERVE BANK OF AUSTRALIA

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Governor

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I would like to start by acknowledging the Gadigal people of the Eora Nation as the traditional owners and custodians of the land on which we are meeting this evening and pay my respects to Elders, past and present.

Thank you to the Committee for Economic Development of Australia (CEDA) for the opportunity to be here tonight. We share an important mission: promoting economic stability and prosperity in Australia. And we also share objectives around economic research and analysis. Groups like CEDA play a crucial role in uniting various sectors of our economy and community to engage in meaningful discussions and debates about the economic challenges facing Australian households and businesses.

We live in an increasingly complex world, with cost-of-living pressures persisting, technological change accelerating, ongoing conflicts in several zones around the world, and an ever-changing geopolitical landscape.

In the face of these numerous global and domestic uncertainties, both our organisations are confronted with significant challenges. Fundamentally, however, the RBA's role and focus has not changed, and we are ready to meet these challenges head-on.

Tonight, I will present the RBA's analysis of economic conditions both domestically and internationally. I am often asked, 'why aren't we cutting rates yet in Australia?' and so, I will reflect on our monetary policy strategy and how it compares with some of our global peers. I will also provide an update on changes to our monetary policy processes.

While monetary policy is central to the RBA's mandate, our responsibilities encompass a broader range of activities that support the overall functioning of the Australian economy. I will therefore conclude by highlighting some of the initiatives we are undertaking and the transformation underway at the RBA to ensure we are well placed to meet the challenges of today and tomorrow.

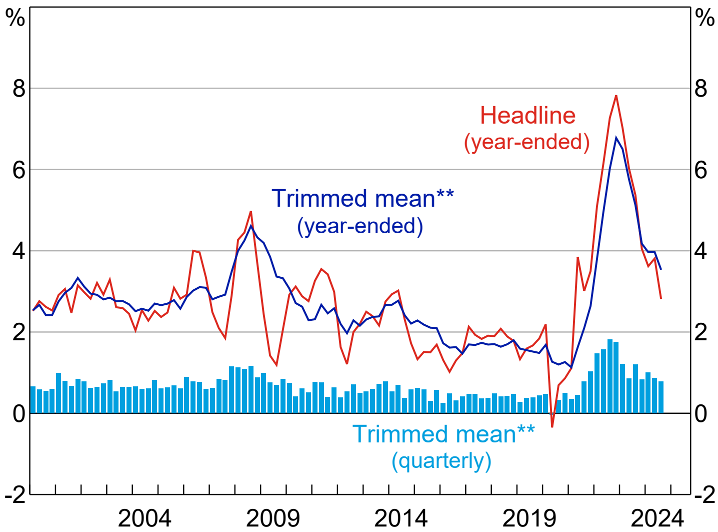
Domestic economic conditions

First, to economic conditions here in Australia.

Headline inflation eased to 2.8 per cent over the year to the September quarter of 2024, down from 5.4 per cent over the year to the September quarter of 2023 (Graph 1). This is welcome relief for people feeling the pinch from the rise in the cost of living over the past two years – which is everyone, but particularly the more vulnerable people in our community. But despite the decline there is still some way to go to return inflation *sustainably* within our 2–3 per cent target range. The word 'sustainably' is important because it recognises that we need to look through temporary factors that influence the headline inflation rate from time to time. Indeed, over the past year, part of the decline in headline inflation has been due to temporary factors such as electricity rebates and declining fuel prices. While these temporary factors have undoubtedly helped many Australians, our approach is to look through them to some extent to better understand where inflation will settle in the medium term.

Graph 1

Measures of Inflation*



* Adjusted for the tax changes of 1999–2000.

** Excludes deposit & loan facilities prior to the September quarter of 2011.

Sources: ABS; RBA.

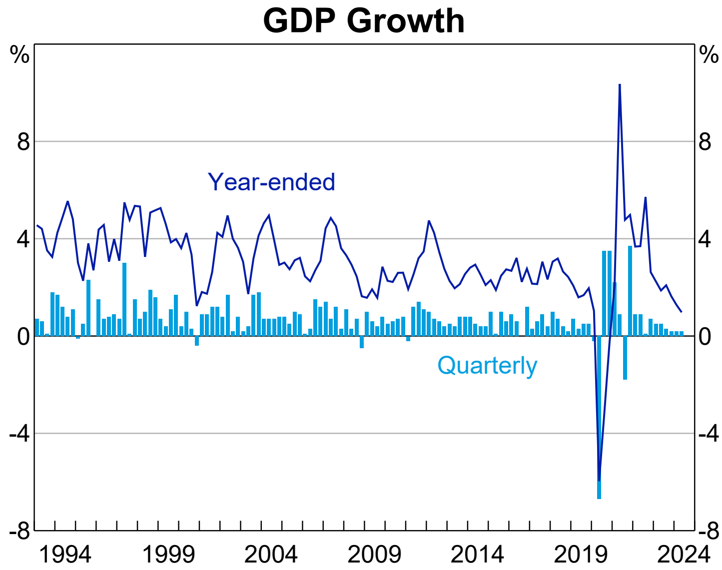
The best way to do this is to look at underlying inflation. The measure we typically look at for this is trimmed mean inflation and by this measure, inflation was still too high at 3½ per cent over the year to the September quarter. While this is a welcome decline from 5.1 per cent a year earlier, it is consistent with a situation in which the overall level of demand for goods and services in the Australian economy has been outstripping its supply capacity for some time.

We have maintained the cash rate at its current level of 4.35 per cent for a little over a year now. This is 4.25 percentage points above its emergency low level of 0.1 per cent at the height of the pandemic. At this current level, we are of the view that monetary policy is restrictive. The effect of this is most evident in the household sector, with very weak growth in consumption, a decline in per capita consumption and very low dwelling investment.

Monetary policy settings will nevertheless need to remain restrictive until the Reserve Bank Board is confident that inflation is on track to return sustainably within the target range and approach its midpoint of 2.5 per cent. Our forecasts published in the November *Statement on Monetary Policy* suggest that a sustainable return to target will occur in 2026.

Elevated inflation indicates that the level of demand in the economy is above the ability of the economy to supply the goods and services demanded. But the evidence suggests that this gap is narrowing (Graph 2). One reason for this is that the rate of *growth* in demand has been quite subdued. The subdued rate of GDP growth, in turn, reflects the notable weakness in household consumption mentioned earlier. Looking ahead, we anticipate a slight uptick in both GDP growth and household consumption, over the coming year but there are risks in both directions.

Graph 2

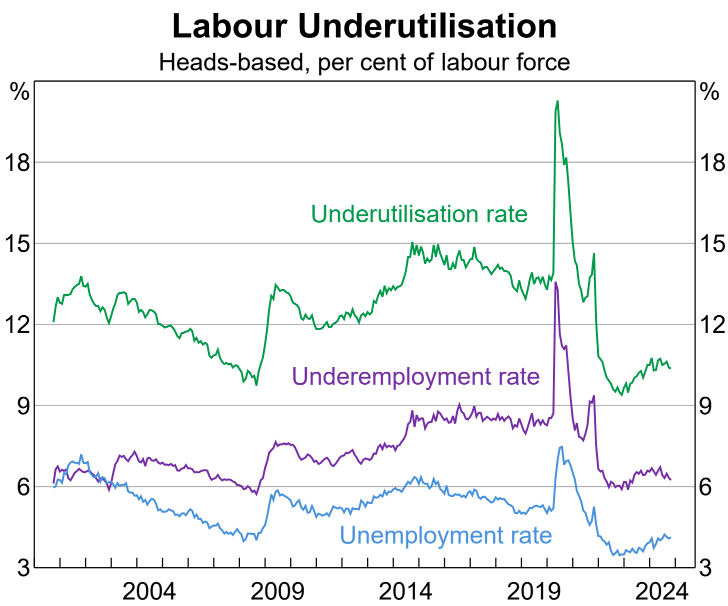


Source: ABS.

One important influence on the outlook for household spending is conditions in the labour market. At present, we judge that conditions in the labour market remain tighter than what would be consistent with low and stable inflation.

This assessment is informed by a wide range of indicators (Graph 3). As a summary, the unemployment rate is currently hovering around 4.1 per cent, which is notably low by historical standards and compared with many other countries. In addition, the increase in the unemployment rate over the last two years has been significantly smaller than some other countries. While some labour market indicators have shown signs of easing, the demand for workers remains robust, particularly in sectors like health care and education.

Graph 3



Source: ABS.

Overall, the earlier period of high inflation has imposed large costs on families and businesses across Australia, and especially the most vulnerable. If we fail to bring inflation down in a sustainable way, cost-of-living pressures will only compound and monetary policy would need to remain restrictive for longer. This is why returning inflation sustainably to the target within a reasonable timeframe remains the Board's highest priority.

Our monetary policy strategy

Recently, I have been asked why other central banks are lowering interest rates and the RBA is not. To explain this, I need to describe what the Board is trying to achieve and ways in which we seem to be a little different from some other peer economies.

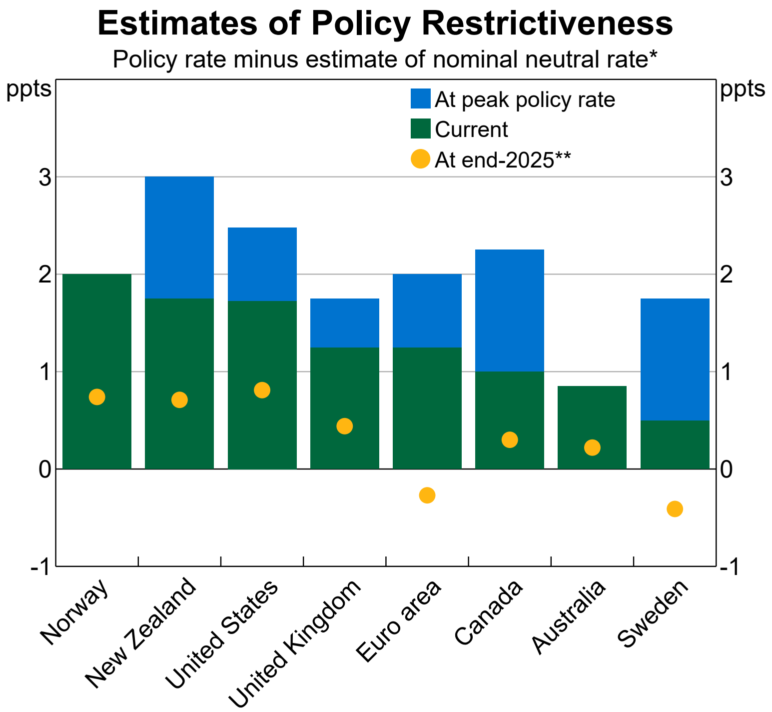
The Board sets monetary policy to achieve domestic policy objectives – that is, for inflation to be about 2.5 per cent and the labour market at sustainable full employment. As it currently stands, underlying inflation is still too high to be considering lowering the cash rate target in the near term.

The Board's strategy over recent years has been to set monetary policy in a way that returns inflation sustainably to target in a reasonable timeframe, alongside a gradual easing in labour market conditions to levels consistent with sustainable full employment. The goal underpinning this strategy has been to preserve as many of the jobs that have been created over recent years as we can. This is what we have previously referred to as the 'narrow path'.

When setting policy, the Board aims to ensure that financial conditions are restrictive enough until it is confident that inflation is moving sustainably back to target. This overarching approach is similar to that used at other central banks in advanced economies, where we all have flexible inflation targeting frameworks.[1]

All central banks care about inflation and the potential impact of their policies on the economy and the labour market. But there have been some important differences reflecting the different weights that central banks place on the two objectives. In Australia, interest rates did not reach the same levels of restrictiveness as many other countries (see the blue bars in Graph 4), and consistent with this, inflation has been somewhat higher relative to target here than in most of those economies, and the labour market is also tighter. This means that even with a similar approach to setting policy, the time to adjust domestic monetary policy settings can differ from peer central banks.

Graph 4



* Estimate of nominal neutral rate from each central bank.
** Using market participants' policy rate expectations.
Sources: Bloomberg; central banks; RBA.

Indeed, Australia's labour market conditions appear unusually tight, relative to those in other peer economies. Conditions in labour markets in those economies have eased significantly and unemployment has increased, such that labour markets are now assessed to be close to balance or have spare capacity. Given the tightness in Australia's labour market, along with our assessment that the level of demand still exceeds supply in the broader economy, we expect it will take a little longer for inflation to settle at target in Australia.

Peer central banks have eased policy settings as they have become more confident that inflation is moving sustainably back towards their respective targets, but so far most have also stated that they are removing only *some* restrictiveness. That is, central banks globally are still pushing against high inflation despite pulling back on the extent of restrictiveness somewhat. With their inflation rates now close to target and the easing they have seen in their labour market conditions, they are turning their attention to downside risks in their economies and labour markets.

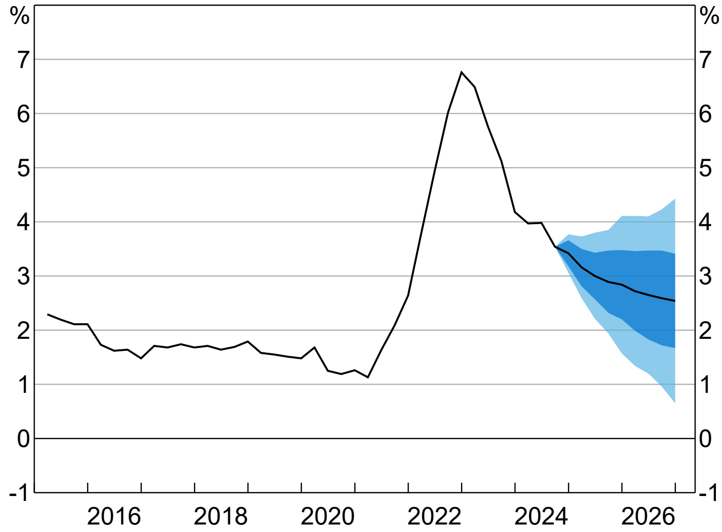
Looking ahead for Australia, RBA staff expect inflation to return sustainably to the 2.5 per cent midpoint of the target range by late 2026 as restrictive financial conditions gradually bring the economy and labour market into better balance. We still think we are on the narrow path. This staff forecast was conditioned on a forward path for the cash rate implied by market pricing at the time of the November *Statement on Monetary Policy*, which had the cash rate remaining at its current level over the near term.

I should be explicit here that this is not the Board's forecast for interest rates. It is a conditioning assumption but, along with other information available at the time, it is consistent with inflation returning sustainably to target within the Board's preferred timeframe. That said, the central forecast for inflation has substantial bands of error around it so as more information comes to hand, we will be reconsidering those forecasts and hence the appropriate stance of policy (Graph 5).

Graph 5

Trimmed Mean Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

The monetary policy process

The process that supports the Board's monetary policy decisions is evolving.

As many of you will recall, the Board previously met monthly for half a day on the first Tuesday of the month (except for January). This year, however, the Board has met seven times, with the eighth and final meeting for 2024 to be held in December. The length of the meetings has increased to a full day, spread over a Monday afternoon and the following Tuesday morning. This change may seem quite small, but it has had an important impact on the monetary policy decision-making process. Specifically, stepping down to eight longer meetings has allowed for more deliberation and debate among the Board members. More time between meetings has also meant that there is more new information for the Board to reflect on and consider.

The change to Board meetings has also allowed the RBA staff to adapt our processes to better support the Board's decision-making. We have redesigned our staff-level meetings to focus more on the big questions and risks to the outlook and monetary policy. We are actively encouraging a greater range of diverse perspectives and challenge to make sure we are turning over every stone; a summary of those different ways of viewing the economy is provided in the Board papers at each meeting. Also, external Board members now meet regularly with a wider range of staff to discuss topics relevant to their decision-making. This is just one way in which we are bringing to life our cultural vision for being open to ideas and dynamic in how we work.

The briefings that Board members receive now regularly include policy alternatives, scenarios, and discussion of the trade-offs between the RBA's objectives of low and stable inflation and full employment. We have drawn inspiration from peer central banks to enhance our practices, and they will continue to evolve as we learn what works well here and how we can do even better.

The RBA has always produced high-quality analysis and our staff are well respected for their expertise. But challenging questions lay ahead, and we are best placed to tackle them by continually reflecting on how we can do things differently and what we can learn from others. In this spirit, we are broadening – and deepening – our capabilities, our models and our engagement with people, ideas, and organisations outside of the RBA.

One example of this is our new Monetary Policy Strategy team, tasked with deepening our policy analysis by encouraging debate and collaboration, and harnessing know-how, from within and outside the RBA.

You will also have noticed changes in how we communicate. I have held media conferences after each of the Board's decisions this year, and these will continue next year.

Our publications are evolving too. The *Statement on Monetary Policy*, which we publish four times a year, has been restyled to be more transparent about our forecasts and assumptions, and to give clearer explanations for our assessment of the economy and the risks around the baseline outlook. The *Financial Stability Review* has also undergone a change, with a greater focus on clearer messages to explain our analysis. We will continue to develop these publications as we enhance our communications strategy.

Our transformation agenda

Our transformation goes beyond reshaping how we set monetary policy.

In April last year, we launched a four-year transformation program based on the RBA Review findings. We set out to become a more open and dynamic central bank, trusted for our analysis and service delivery.

Now in the second year of this initiative, we have made significant progress, but much work remains.

We are an organisation with a broad set of responsibilities: we regulate the payments system and run the infrastructure used to settle payments; we provide banking services to the Australian Government, making payments that many Australians rely upon; we issue banknotes that, despite an overall decline in cash transactions, remain an integral part of the Australian economy; and we monitor and contribute to financial stability in cooperation with other authorities. We remain committed to communicating clearly with the public about what we do and why.

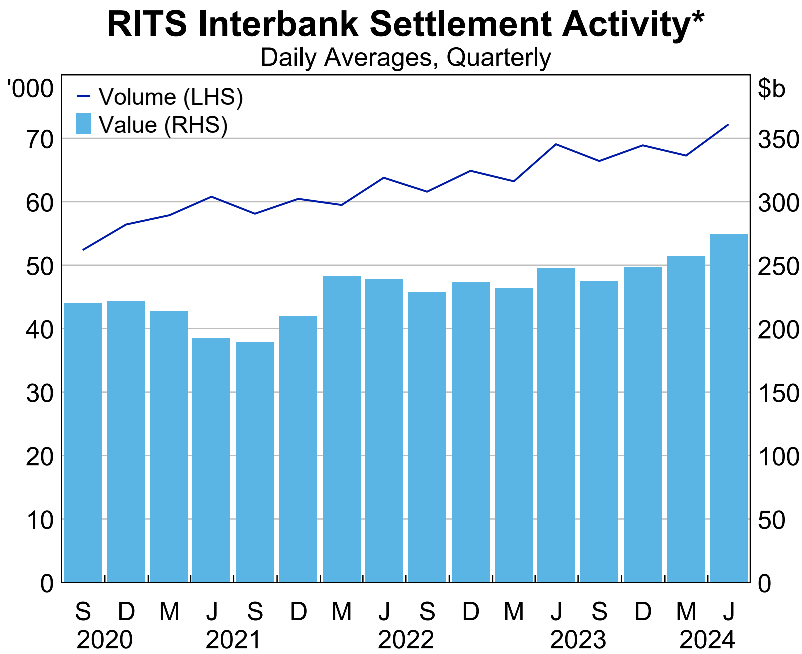
Because of this breadth of responsibility, our transformation is complex. It involves enhancing leadership capabilities, creating a more open and dynamic culture, streamlining operations for greater efficiency, and building resilience – goals shared by many organisations across Australia.

An often-overlooked aspect of our role is our involvement in running the critical infrastructure used to settle payments. We are at the core of this system, ensuring it functions in a way that can be relied upon by the households and businesses that make up our economy. We are also the regulator of the payments system, with a mandate to promote competition, efficiency, and safety of the payments system.

In practice, nearly every electronic payment in Australia relies on the infrastructure operated by the RBA – whether it's tapping a card for public transport, receiving a salary, or transferring money – and many are processed in real-time.

Last financial year, the RBA settled approximately three million payments daily, worth almost $260 billion dollars – an amount equivalent to Australia's GDP roughly every ten days (Graph 6).

Graph 6



* Excluding FSS transactions.
Source: RBA.

Think of the payments system as a train network, with the economy as the train moving vast volumes of transactions. We lay and maintain the tracks that keep money flowing throughout the economy, supporting a strong financial system and efficient payments.

As the payments ecosystem evolves, new players like digital wallets and 'buy now, pay later' services have emerged, enhancing competition and consumer choice. However, these new entrants also introduce risks that may fall outside our current regulatory scope. Proposed amendments to the Payment Systems (Regulation) Act aim to bring these new players inside our regulatory perimeter. But in the meantime, we are consulting on some issues that we do have oversight of – our regulation of card payment systems and the role of surcharging. We expect the Payments System Board to consider and respond to this consultation in the first half of next year.

In addition to consulting on the regulatory settings, we are also investing significantly in our systems and technology to keep pace with rapid technological changes, the growing use of digital payments and challenging security environment. The train tracks now need some maintenance. Ultimately, we need to maintain a modern technological framework that supports our operational and strategic objectives. These initiatives will modernise the infrastructure that powers our nation's payments and banking systems and allows money to move around the economy in a safe, efficient, and reliable way.

Closing remarks

The RBA has a pivotal role in promoting the economic stability and prosperity of Australia. We are currently facing significant challenges posed by persistent inflation, shifting geopolitical dynamics and the rapid pace of technological change. Yet, these challenges also present us with opportunities to innovate and adapt.

Our transformation agenda is not simply a response to current pressures; it is a proactive approach designed to meet the needs of the Australian economy and people today and well into the future.

By enhancing our decision-making processes, embracing transparency, and engaging with diverse perspectives, we are positioning ourselves to navigate the complexities of the modern economy effectively.

I look forward to taking your questions.

Endnotes

* I am grateful to Meredith Beechey-Osterholm, Samuel Evangelinos, Michelle Lewis, Michelle Wright and Jono Vandenberg for excellent assistance with this speech.

1 The Costs of High Inflation | Speeches | RBA