Speech

Policymaking at the Reserve Bank

RESERVE BANK OF AUSTRALIA

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Thank you for the opportunity to address AFIA's conference. AFIA's membership is very broad – bringing together people from traditional ADIs to newer technology-driven entrants and fintechs. One thing you all have in common, however, is that you are influenced by the economy and interest rates. And these days, developments in the payments system are critical to your businesses. The Reserve Bank is a key player in both these areas.

I am going to cover off two topics today. First, I will discuss how the Bank and the Board come to decisions on monetary policy. This part will act as an update to a speech made by Glenn Stevens in 2009 where he set out the internal Bank processes for making monetary policy decisions.[1] It will also highlight some of the innovations made since then, particularly in terms of data, that we now use for monitoring the economy – these innovations have come about because of advances in technology and its impact on our digital lives.

The second part of my remarks will address developments in the payments space.

The monetary policy process

The Reserve Bank's obligations with respect to monetary policy are set out in the *Reserve Bank Act 1959*. In short, they are stability of the currency, full employment and the welfare of the people of Australia. In practice, we interpret this to mean that the Bank should control inflation while taking account of the impact on employment and financial stability.

The framework we use for controlling inflation was set out by the Governor in a recent speech.[2] We aim to have consumer price inflation average between 2 and 3 per cent over time. How do we go about determining every month the best stance of monetary policy in order to meet this goal? The first step is extensive ongoing monitoring and analysis of data on inflation, the domestic and international economies, financial markets and financing conditions.

Monitoring and data

There are two parts to our ongoing analysis. The first is understanding the current economic situation and trends. For this, we use many different data sources. Central to our analysis of domestic economic activity is data produced by the Australian Bureau of Statistics (ABS). The ABS produces high-quality data on all aspects of the Australian economy – income, production, the labour market, trade, investment, consumption, inflation and so on – which provides us with a good view on where the economy is at and the trends within it.

There is also a large variety of data produced by other public agencies and the private sector, and we use many of these partial indicators to supplement the official data. For example, we obtain data on loan commitments from the Australian Prudential Regulation Authority (APRA) as well as data that allows us to measure credit and deposits. Surveys of business and consumer sentiment, and job advertisements are also important partial indicators that we follow closely.

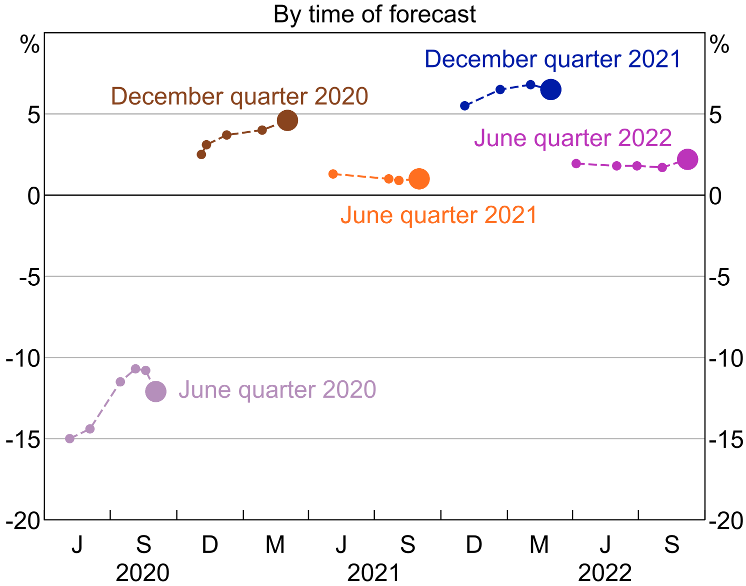
Over recent years, there has been an increasing availability of very timely information that has supplemented the traditional data. Many of these data sources are artefacts of the online and digital lives we all now lead. They come from both the public and the private sector. And it turns out that many of these are valuable for understanding what is going on in the economy.

During the pandemic in particular, we used these data in a much more structured way for our analysis. A good example of this was the use of timely information on household spending and activity. Like many policymakers around the world, staff at the Bank used this information to get a better real-time assessment of household consumption, which was critical to our assessment of the economy during the pandemic. Bank staff used this partial information to develop a monthly 'consumption tracker' – an estimate of aggregate household consumption that is available well ahead of the ABS national accounts.[3] Some of the data sources it uses are card transactions, restaurant bookings, flight departures, Medicare benefits and mobility data. These data allow us to get a more up-to-date reading on what households are spending their money on. And it does a pretty good job. Graph 1 shows the performance of the consumption tracker over the past couple of years. Because there is a need for forecasts for some components of consumption, as well as judgement on the price and quantity of contributions, the estimates can move around from month to month. However, broadly, it has given us a good estimate of the actual change in household consumption a few months ahead of the publication of the national accounts.

Graph 1

Quarterly Consumption Growth*

By time of forecast



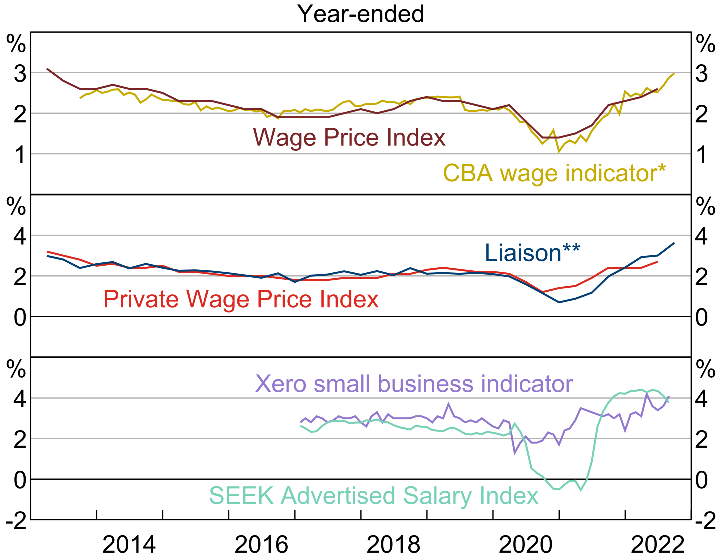
* Small dots indicate RBA growth estimates; large dots indicate actual growth figures from the latest vintage of the ABS national accounts.

Sources: ABS; RBA

Another area where we have timely information is the labour market and wages (Graph 2). While we have had business surveys such as the NAB and AIG surveys for some time, during the pandemic the ABS started publishing data on payrolls using Australian Taxation Office (ATO) data from the single-touch payroll tax collection process. CBA now produces a monthly wage indicator using data from its customer base, and SEEK has recently started producing an advertised salary index based on jobs posted on their platform. In addition, accounting software company Xero uses data from its large number of small business customers to compile several monthly business indicator indices, including on wages growth.

Graph 2

Timely Measures of Wages Growth



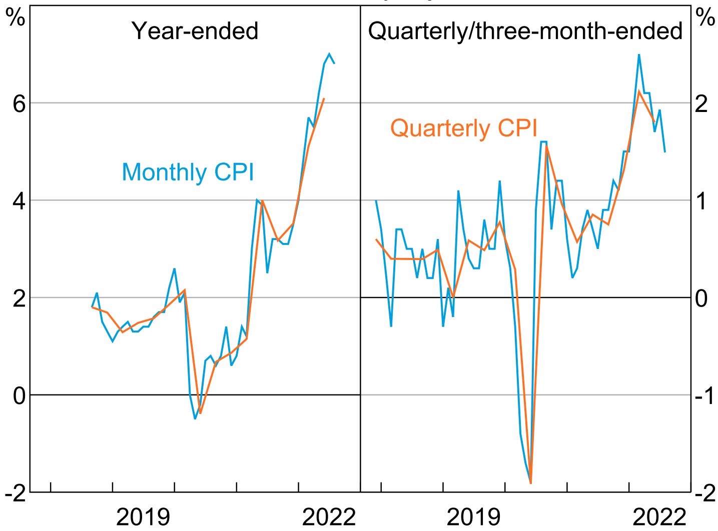
* Changes in base wages based on a sample of CBA retail banking transactions.

** Private sector; trimmed mean; rescaled to have the same mean as the private Wage Price Index.

Sources: ABS; CBA; RBA; SEEK; Xero Small Business Insights

The ABS has been using many of these new data sources to improve its statistics and provide additional, timely information. The monthly Consumer Price Index (CPI) indicator is another example of ABS innovation in this area. Although it is not as comprehensive as the quarterly CPI, it gives us a much more timely reading on the 'inflation pulse' (Graph 3). Again, technology has provided a great opportunity here. The scanning technology used by supermarkets, for example, provides the ABS with a very timely and comprehensive read on grocery prices. And I expect that the monthly CPI indicator will only improve as our digital lives produce more data and we continue to refine techniques that make best use of it.

Graph 3
Headline Inflation
Non-seasonally adjusted



Sources: ABS; RBA

The final element of the Bank's monitoring and analysis is our business and community liaison program.[4] This program has been running for more than 20 years; however, it has come to prominence lately because we have been more explicit about how it is shaping our thinking about wages in particular. Bank staff across the country are continually meeting with businesses, government agencies and community groups to better understand what is happening right now and what is likely to happen in the future. We gather this information in a systematic and structured way that allows us to generate useful summaries on current conditions. We have been increasingly reporting insights from the program in the *Statement on Monetary Policy* and a regular dedicated summary of liaison messages will be included in the Statement from the November 2022 issue.

The second part of our ongoing analysis of output and inflation for the monetary policy process is the outlook – that is, given what we know about the current economic conditions, what does this imply for the future? This is important because, while we know monetary policy has 'long and variable lags', we need to form a view about how interest rate moves now might impact the economy and inflation in the future.

The forecasting process is an amalgam of a number of things. First, we need to understand where the economy currently is, its direction of travel and any emerging trends. This process of data monitoring and analysis that I have just described is the bedrock. From here, we use a mix of formal models and judgement.

Recognising that no single model can provide us with all the answers, we draw on a variety of models to make our forecasts. For most of the key macroeconomic variables – such as consumption, inflation, wages or the unemployment rate – we have formal econometric models. Comprehensive econometric models – including the full system economic model, MARTIN – are used to underpin our forecasts, develop alternative scenarios and perform sensitivity analysis.

All this analysis and forecasting ultimately finds its way to the Board. But, before it gets there, it goes through a rigorous internal process of testing and challenge.

The lead up to the Board meeting

The Board meets on the first Tuesday of every month except January. This frequency of meetings is quite unusual internationally. I will come back to this point later on.

The monthly Board cycle follows a process that has been refined over many years. It starts with the preparation of 'Monthly Reviews' two weeks prior to the Board meeting. These reviews document what we know about domestic and international economic conditions and financial markets, as well as key messages from liaison, which will ultimately form the basis of papers that will go to the Board.

From this follows a sequence of meetings at which current conditions and the outlook are discussed and views on monetary policy sought. It starts with small groups of staff in Economic Group and Financial Markets Group, where staff debate among themselves and views are sought on policy decisions.

Economic Group and Financial Markets Group then hold group-wide meetings that are attended by the Governor and Deputy Governor. At these meetings, staff present key updates in their various areas of responsibility and this is followed by a discussion of monetary policy. Lead-off speakers are sometimes scheduled to make cases for different policy options. Staff are encouraged to offer their views on the recommendation to the Board. For example, in most recent months, this has included views on the size and timing of interest rate increases; in the past couple of years, it included views on the use of unconventional monetary policy tools, their size and when it would be appropriate to adjust or cease them.

One week prior to the Board meeting, the Policy Discussion Group (PDG) is held. It is chaired by the Governor and attended by many of the senior executives of the Bank. Each month, at least two papers are discussed – 'Economic Conditions' and 'Financial Markets'. The discussion starts with the information provided in the papers. What is the information telling us about the state of the economy? About financing conditions? How should we interpret recent data? Following this, the meeting is open for views on recommendations to the Board. There is typically very open discussion at this point. There is never any shortage of views and there are often notable differences of opinion. The Governor encourages debate and actively calls for contrary views. There is also discussion about the communication challenges associated with particular policy options.

Following PDG, the 'Monetary Policy' paper, including the recommendation to the Board, is finalised by the Assistant Governor (Economic) with input from the Governors, the Assistant Governors of the Financial Markets and Financial System groups and the Head of the Economic Analysis Department.

The Board meeting

At 9 am on the first Tuesday of the month, the Board members meet. A variety of materials is circulated to all members ahead of the meeting, including the 'Economic Conditions' paper, the 'Financial Markets' paper and the 'Monetary Policy' paper. There are typically other papers circulated. For example, twice a year the 'Financial Stability' paper is presented to the Board by the Assistant Governor (Financial System). In fact, the 'Financial Stability' paper was discussed at the most recent meeting and the analysis contained in that paper was published in the October *Financial Stability Review*. In addition, four times a year the Board receives a paper on the 'Economic Outlook', which summarises the staff's forecasts and views of the risks and uncertainties. This paper ultimately forms the basis of the 'Outlook 'chapter in the *Statement on Monetary Policy*. An annual forecast review is also provided. Finally, there are regular 'special' papers that cover topics that warrant a separate discussion because of their importance and often medium-term nature. Examples from recent years include the neutral interest rate, various aspects of unconventional monetary policy (both options and mechanics), inequality and monetary policy, and the implications of climate change.

At the Board meeting itself, the Assistant Governors for Economic Group and Financial Markets Group deliver presentations that cover the key themes relevant for the Board's discussion that month. The Board members are active in this discussion – they ask a lot of questions, not only to understand the issues better but also to challenge the interpretation of the staff. Members also bring their own knowledge of economics, finance and wider commercial experiences to bear.

At the most recent meeting in October, the process that I have described culminated in a decision to increase the cash rate by 0.25 percentage points to 2.6 per cent. There was no doubt that a further increase in interest rates was warranted. Inflation is too high in Australia and is expected to rise further. While a lot of this can be explained by global factors such as supply chain disruptions and energy prices, there is an important element of strong domestic demand. Indeed, the labour market is very tight – unemployment is as low as it has been in around 50 years – and this is starting to put upward pressure on wages. For all these reasons, interest rates need to rise to ensure inflation returns to the 2 to 3 per cent band over time and that inflationary expectations remain anchored.

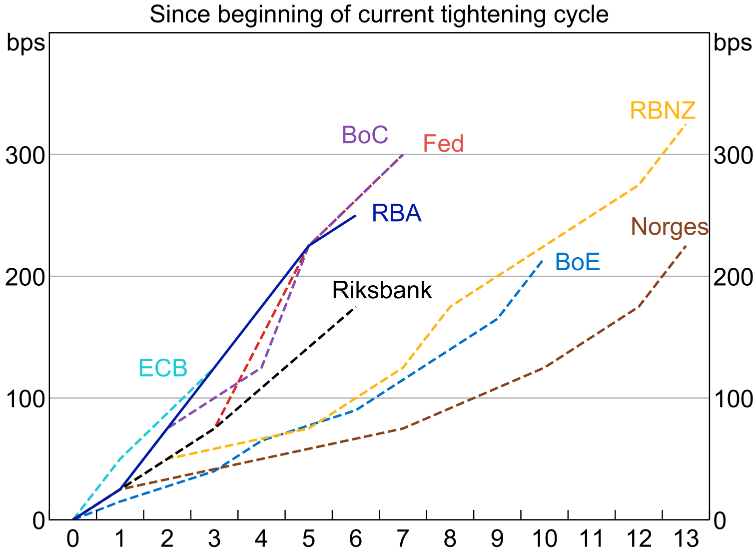
But there was an active discussion both internally and at the Board meeting about the appropriate size of the increase. On the one hand, inflation is high and the labour market is very strong, which indicates a need for interest rates to rise further. On the other hand, there has already been a substantial rise in interest rates since May, which, along with price rises, is beginning to put pressure on household budgets. How household spending will respond to this is uncertain. The international economic environment has also deteriorated quite sharply. For these reasons, the Board felt that a smaller increase in October was warranted while it took stock of developments in consumption, wages and the international economy.

Some commentators have contrasted the Board's decision to raise rates by 25 basis points with those of overseas central banks that have been increasing interest rates by larger increments. In part, this reflects our particular economic circumstances. But it is also relevant that the Board meets more frequently than most of our peer central banks. The Reserve Bank Board is making monetary policy decisions 11 times a year so it is discussing regularly the evidence on the economy and has more flexibility on the size and timing of rate increases. This is a particular advantage in uncertain times, as it allows more frequent evaluation of the evidence and recalibration if necessary. It also means that if we increase interest rates at every meeting, we can potentially move much faster than overseas central banks. Or, alternatively, we can achieve a similar rise in interest rates with smaller increments. The incremental change in the policy rate at recent meetings has been smaller than some other major central banks. However, our policy rate trajectory has been as steep, or steeper, than other central banks (Graph 4).

Graph 4

Policy Rate Trajectory*

Since beginning of current tightening cycle



* Monthly increase in the key policy rate since the first rate increase in the tightening cycle.

Source: Central banks

The Board expects to increase interest rates further over coming months. But the pace and timing will be determined by the economic data. Factors that the Board will be monitoring closely include the global economy, household spending and wage- and price-setting behaviour. You should be in no doubt, though, that the Board is determined to do what is necessary to return inflation to target.

The payments system

I suspect most of you in this room are involved in payments in one way or another. What used to be regarded as the boring plumbing of the economy is now at the forefront of innovation. The community has come to value quick, cheap and seamless payment services, and technology is increasingly providing this.

Payments has changed substantially over the past couple of decades. In the late 1990s, payments was all about cash, cheques and direct entry. But credit cards and eftpos were starting to become important. Banks were at the centre of the payments system, providing services to merchants and consumers.

The payments ecosystem couldn't look more different today. Cards are the most commonly used payment instrument, but now we 'tap and go' rather than 'clacking' or 'dipping'. They are used online as well as face to face. And in many cases, they are not even physical cards but digital representations of cards on a variety of devices. We have a fast payments system that allows person-to-person payments in a matter of seconds. Customers can pay for goods and services using buy now pay later (BNPL) services – effectively digitising instalment credit/laybys.

Furthermore, payments is no longer simply the domain of the banks. We have non-bank acquirers of card transactions, payment gateways, payment facilitators, mobile wallet providers, BNPL firms and cross-border payment specialists. And now we have 'stablecoins' on the horizon.

This has led to a few key priorities. In the interests of time, I'll focus on three.

First, we are working with Treasury to implement the reforms to the payments system regulatory framework that were recommended in the Review of the Australian Payments System in 2021. There are a few key elements to this. First, there is amendment of the legislation to ensure that the Bank's regulatory perimeter is broad enough to capture new payment systems and payment system participants. Second, there are a number of new regulatory regimes to be developed that are intended to assist non-banks to participate directly in the payments system.

A critical priority is the development of a regulatory regime for payment service providers, along with common access requirements for payment systems. Non-banks have consistently noted that they are at a competitive disadvantage because they are often unable to gain direct access to payment systems – they have to connect through a direct participant, typically a bank. The argument of the payment system operators has generally been along the lines of 'participants bring risk to the system so they need to be supervised to join the system'. This makes it difficult for payment service providers that are not banks and do not need to be banks for the services they provide. A licence that is proportionate to the risks that payment service providers bring to the system, coupled with some common access requirements, would make it easier for non-bank payment service providers to participate directly in payment systems if they choose.

A part of this regime will include a simplified licencing process for stored value facilities. These payment service providers typically have fairly simple business models. They receive money from customers, which they can then use to make payments using cards or mobile wallets. Some of these providers allow international payments. At the moment, these entities face a rather convoluted supervisory regime involving the Australian Securities and Investments Commission (ASIC), the Bank and APRA. This reform has been on the agenda for a number of years but is yet to be addressed by legislation. However, it has become increasingly important as the number of stored value facilities has risen. The rise of payment stablecoins – which look very much like stored value facilities – has given further impetus to this.

A second key priority is to support the shift to digital payments. There are a number of strands to this work but the one I would like to highlight here is developments in the New Payments Platform (NPP). The Bank is a great supporter of the NPP. It delivers real-time payments person to person. And, with PayID, it provides more security for those payments, since you receive confirmation of who you are paying before you commit to the payment. But it also provides the opportunity for so much more. PayTo is a great innovation that will give consumers more control over their payment authorities. This has been an issue as long as I have been in the payments area. It is a consistent complaint from customers attempting to move banks – it is too difficult to move all of their direct debit authorities. PayTo will provide opportunities for many innovative companies to provide services to their customers. It is disappointing that so many banks are yet to get their PayTo service up and running. The Payments System Board has indicated that it expects all the major banks to meet their commitments to provide this service by April 2023 to realise the full potential of PayTo.

A third key priority is research into central bank digital currencies (CBDCs). While up to this point we have been somewhat sceptical about the case for 'retail' CBDCs (like a digital representation of banknotes), we have been more open minded about the case for wholesale CBDCs being used as part of a real-time settlement process for digital assets. Nevertheless, we are interested in potential use cases to help answer the question on whether there should be a general purpose Australian CBDC. This is why we are engaging with industry through a digital AUD pilot program with the Digital Finance Cooperative Research Centre (DFCRC). With the DFCRC, we recently issued a white paper setting out the project and asking for business proposals.[5] This is quite a big step. Rather than just a proof of concept, this pilot project will involve a real claim on the Reserve Bank. Our focus is not on the technology as such but on use cases. We are inviting firms to come forward with their innovative ideas to test a digital AUD. So far, there has been quite a bit of interest from traditional financial institutions through to fintechs.

Conclusion

I hope this brief discussion of the Reserve Bank's monetary policy process has given you some insight into the Board's monthly interest rate decision. I hope also to have given you a flavour of the way in which new data sets are helping us and others to monitor economic conditions in a more timely way. As for the payments system, things are changing fast and an important part of the Bank's role is to keep up with developments. Our strategic priorities reflect this.

Thank you for your attention.

Endnotes

[1] Stevens G (2009), 'The Conduct of Monetary Policy in Crisis and Recovery', Address to The John Curtin Institute of Public Policy and the Financial Services Institute of Australasia Public Policy Breakfast Forum, Perth, 15 October.

[2] Lowe P (2022), 'Inflation and the Monetary Policy Framework', Speech to the Anika Foundation, Sydney, 8 September.

[3] Bishop R, J Boulter and T Rosewall (2022), 'Tracking Consumption during the COVID-19 Pandemic', RBA *Bulletin*, March.

[4] Dwyer J, K McLoughlin and A Walker (2022), 'The Reserve Bank's Liaison Program Turns 21', RBA *Bulletin*, September.

[5] See RBA and DFCRC, 'Australian CBDC Pilot for Digital Finance Innovation –White Paper', September.