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Members: Mr Baird (Chair), Ms Bird (Deputy Chair), Mr Ciobo, Dr Emerson, Ms Grierson, Mr Keenan, Mr McArthur, Mr Secker, Mr Somlyay and Mr Tanner

Members in attendance: Mr Baird, Mr Ciobo, Dr Emerson, Ms Grierson, Mr Keenan, Mr McArthur, Mr Somlyay and Mr Tanner

Terms of reference for the inquiry:
To inquire into and report on:
Reserve Bank of Australia annual report 2006
WITNESSES

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BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia

EDEY, Dr Malcolm Lawrence, Assistant Governor, Economic, Reserve Bank of Australia

LOWE, Dr Philip William, Assistant Governor, Financial System, Reserve Bank of Australia

STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia

CHAIR (Mr Baird)—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration. I welcome representatives of the Reserve Bank, students and staff from secondary schools in the Gold Coast area, members of the public and the media. The hearing today provides an opportunity to examine in more detail the recent increase in inflation and inflationary forecasts which prompted the bank to increase the cash rate by 25 basis points to 6.50 per cent. The committee will investigate whether this action by the bank will reign in inflationary pressures over the short to medium term or whether there are any lingering upside risks for inflation.

The committee will also seek views on other significant issues, including the state of the international economy—especially in the light of recent events in the US subprime mortgage market—consumer confidence, household balance sheets and the productivity conundrum discussed at February’s hearings. It appears from the August statement of monetary policy that the variations in economic growth between states are smoothing, with variations in unemployment figures narrowing. The committee would be interested to hear the bank’s view on this.

Once again, on behalf of the committee, I welcome the Governor of the Reserve Bank and other senior officials to this hearing. I remind you that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament.

Before I ask the Governor of the Reserve Bank to make an opening statement, I would like to acknowledge the presence of students from Elanora State High School. Welcome to you. You will have the ability to ask a question close to our morning tea break, so you can prepare your question. Mr Stevens, I now ask you to make your opening statement before we proceed to questions.

Mr Stevens—Thank you very much. Since we last met in Perth, economic conditions in Australia have strengthened. At the same time, more recently financial markets globally have become extremely skittish and there has been a sharp reassessment of risk and a sudden desire for liquidity. I will come to the financial market turbulence shortly, but before I do I think it is worth recounting how the real economy has performed over the past six months. Given the uncertainty being felt in financial markets at present, it is, I think, important to keep a clear sense of the economic fundamentals. According to the national income accounts, growth picked up sharply in the December and March quarters. Over the year to March, real GDP is estimated to
have expanded by 3¼ per cent, despite the impact of the drought. The non-farm economy was reported as having grown by about 4½ per cent, equal to its fastest pace for four years.

Gauging the true extent of acceleration is not straightforward given the inevitable noise in the data over short periods, but a wide range of survey evidence and other indicators also suggest that the conditions picked up in the first half of 2007. Domestic spending is rising, with robust rises featured among most of the components. The exception is residential construction, where commencements remain flat at slightly below average levels. The demand for credit also appears to have firmed, most particularly among businesses. Household finances, like corporate finances, are generally in strong shape.

Demand for Australian exports is rising too. Success in transporting higher volumes of resources has been mixed, varying by location and industry and according to disruptions caused by weather, efforts at adding new capacity, and port and rail delays in some cases. But the trend is upward and tonnages are set to increase over the next several years as capacity comes online. Agricultural exports will benefit from the improved rainfall in some parts of the country.

Not surprisingly in light of the above, the demand for labour has continued to expand. The recorded rate of unemployment is at its lowest for a generation. Job vacancies are high and surveys suggest that many firms see the difficulty of finding additional labour as among the biggest, or the biggest, impediment to expanding production. As yet, though, the pace of growth in labour costs overall has remained relatively contained.

In thinking about why growth has picked up somewhat more than had been expected, we should not overlook the fact that the global economy has surprised, once again, by its strength. The most recent forecasts for global growth made by the IMF were revised upward only a few weeks ago, with growth now thought likely to be over five per cent in 2007, which is close to the 2006 result. The US economy has slowed but greater strength elsewhere has, to date, more than outweighed the US softening. Australia’s terms of trade have kept rising and stand at a five-decade high. This has added about 1½ per cent of GDP to the annual growth rate and Australia’s national income per year over the past couple of years, which is quite an expansionary force. Some of the resulting demand spills abroad, but there is also a stimulus to spending on non-tradable goods and services arising from the income gains being experienced. The rise in property prices in Western Australia is a case in point.

It would be imprudent to assume that this trend will continue indefinitely; nonetheless, it has already gone considerably further than most observers anticipated. When we lift our gaze beyond the conventional forecasting horizon, the big picture is that the emergence of potentially very large economies like China and India at such a rapid pace and with such consistency is unlike anything that we have lived through before. We cannot be confident, therefore, that the cyclical experience of the past few decades is necessarily a reliable guide to how things will develop.

In its policy deliberations over several months, the board has weighed conflicting trends. When we were last before the committee in Perth, we were observing an apparent moderation in inflation. We were, as you know, at that time still of the view that there could be a need to tighten monetary policy further at some stage. But having made three adjustments in 2006, we
believed that the improving short-term trend in inflation afforded us time to watch developments.

Information that came in over the ensuing period suggested stronger than expected demand in the economy. This meant that the longer term risk of higher inflation was increasing, not diminishing; hence, the likelihood that interest rates would need to be increased at some stage was rising. Moderate price and wage outcomes continued, however, for some months, suggesting that at least temporarily the supply side of the economy was managing to respond to stronger demand. It was doubtful that this could continue over an extended period but, taken together, the weight of evidence suggested that the best course for monetary policy was to maintain the existing setting for the time being but to be ready to tighten should signs of a strengthening of price pressures emerge.

The June-quarter CPI data available for the August meeting showed some pick-up in inflation. This information, together with a stronger growth outlook, led us to expect a somewhat higher path for inflation over the horizon of the coming one to two years. The judgement we reached was that the risk of unnecessarily damaging growth with a modest rise in interest rates was small, whereas the cost of not responding to a deterioration in the outlook for inflation could well be substantial in the longer term. On straightforward macroeconomic grounds, therefore, there was a clear case to make an adjustment to monetary policy.

As our statement on Wednesday of last week set out, the board considered the recent events in international credit markets in coming to that decision. I think it is worth taking a few moments here to set out some history. For some years now, many long-term observers, market participants and officials have been troubled by very narrow pricing for risk—in other words, it has been easier and cheaper than had been normal in the past for risky borrowers to access funding. Investors were prepared to take more risk in pursuit of returns in a world of low global interest rates.

Somewhere or other in this world, returns were eventually bound to disappoint someone. As it turns out, the problems emerged in the US housing sector. Lenders into the so called subprime market attempted to keep the pace of business up as the US housing sector slowed during last year, but they could do this only by lowering lending standards. Before long, arrears began to rise as some borrowers struggled to meet their commitments.

Once this deterioration in underlying asset returns had occurred, those with exposures inevitably began to see losses. Because this type of lending was via securitised structures sold into global capital markets, losses have been coming to light right around the world. In most cases, the losses are embarrassing rather than fatal for the institutions concerned. The exceptions have been where particular funds invested mainly or solely in these types of risky assets, and especially where leverage was involved. Several hedge funds have borne large losses, including some in Australia. All of this created a climate in July and early August in which investors retreated and pricing of risk started to return to levels that could be regarded as more reasonable, based on historical experience. A number of capital raisings that had sought to take advantage of the earlier very generous terms were postponed. Volatility in financial markets increased, share prices declined somewhat and a general sense of heightened uncertainty was evident.
In considering the implications of all this for our decision on monetary policy last week, there were two questions to ask. The first was whether there was information to suggest that financial developments were likely to make a sufficient difference over the relevant horizon for policy to the global economy, and therefore the Australian economy and the inflation outlook, to remove the macroeconomic case for a 25 basis point adjustment to interest rates. On balance, we judged that there was not. Downside risks to the US economy do appear to have increased in recent months, but in other parts of the world the growth outlook has, if anything, been marked higher recently. The second question was whether a rise of 25 basis points in Australian cash rates would in itself be financially destabilising. No credible case could be made for that idea. In fact, it would probably have been more destabilising to expectations not to have carried out a policy adjustment that most people could see was needed. Accordingly, as you know, monetary policy was tightened last week, taking the cash rate to 6.5 per cent.

Subsequently, towards the end of last week, there was a period of stress in some major country money markets. Because the exposures to the mortgage problems in the United States are still coming to light, financial institutions are uncertain over the standing of other market participants. Objectively, it is extremely unlikely that the subprime mortgage exposures could significantly damage the core banking system in any significant country. The exposures have spread far too widely for that to occur. But precisely because they are spread so widely and because the associated financial structures are opaque, the information on who is exposed and by how much is incomplete, hence people remain wary. At times of uncertainty, market participants naturally get more cautious and tend to want to hang on to cash rather than to lend it in the interbank market. In such circumstances, central banks typically respond by being prepared to make additional cash available through purchases of high-quality assets from market participants in sufficient quantities to keep the cash rate at the level required by monetary policy considerations. Several major central banks made very substantial injections in this way on Thursday and Friday of last week in the face of an abrupt shift in cash market conditions.

While the likelihood of a significant problem of this sort arising in the Australian money market was low, last Friday, the Reserve Bank, as part of its normal dealing operations, purchased more assets, hence adding more cash to the system than it otherwise would have done. The intent of this was to ensure that the cash rate remained at the target level set by the board. The market operated normally. Overnight funds were available in the market at 6.50 per cent, exactly as intended. This has remained the case subsequently. Of course, the Reserve Bank remains ready, as always, to ensure that there is adequate liquidity for markets to function normally in the period ahead.

The broader credit market issue is that the losses arising from the US mortgage problems are still being assessed and absorbed. That is producing a degree of uncertainty that is affecting financial markets around the world, leading to tougher borrowing conditions for the moment and considerable volatility.

The fact that the global economy has been so strong, that core financial institutions, after years of strong profits, are well capitalised and that real sector corporate profitability in most countries is very sound will be helpful in coping with tougher credit conditions if they persist. Indeed, global growth as of late has been sufficiently strong that some moderating effects would be welcome. An adjustment to investor behaviour needed to occur and was almost certainly overdue. Such adjustments often are not entirely smooth and are frequently triggered, as in this
case, by the realisation that credit terms had been too generous for too long. Sometimes, however, the ensuing retreat can go too far, resulting in a widespread withdrawal from the provision of credit that unnecessarily crimps the pace of economic expansion. We will therefore have to continue to watch carefully how this all unfolds over the period ahead.

The *Statement on monetary policy* released a few days ago contains our most recent assessment of the outlook. It takes account of the change in interest rates last week as well as the recent flow of data at home and abroad. There are of course various assumptions on which the outlook is based, and these parameters could well shift over time. Recent credit market developments add a further degree of uncertainty about the outlook. Subject to that uncertainty, the picture is one of growth close to trend and the economy remaining close to full employment. Under such circumstances, inflation is likely to be around three per cent over the coming year and near the top of the target zone in the following year.

As far as risks to that forecast are concerned, the possibility that the world economy might end up being weaker than assumed due to the persistence of credit difficulties is one that obviously everyone will have in mind at present. At the same time, there is also the possibility that ongoing strength of demand in a fully employed economy might leave us with inflation pressure that is harder to manage than expected. These possibilities and various other things that could come along unexpectedly will naturally be issues that the board will have to assess each month. For now, my colleagues and I are here to respond to your questions. Thank you.

**CHAIR**—Thanks very much, Mr Stevens. Before we move on, is it the wish of the committee that the statement by the Governor of the Reserve Bank be accepted as evidence and authorised for publication? There being no objection, it is so ordered.

Nerang school and Canterbury College have now arrived. Because you were not here earlier, before the morning tea break you will be given the opportunity to ask one question each from your school to the governor.

Governor, thank you very much for your review. Thank you for coming here to the Gold Coast, which is an important part, in terms of its growth, of the Australian economy. Because of the events that have occurred during the past several weeks and particularly this week, it is important that we look first at the world economic market and particularly the subprime situation or lending situation in the US, the level of delinquencies that are occurring there, and the flow-on to the Australian market—to what extent we are exposed. I noticed that Ralph Norris, the chief executive of the CBA, said yesterday in handing down his annual report that profits for the nation's big banks should hold firm in the face of the global liquidity crunch because of their relatively low reliance on the volatile wholesale debt market.

I am interested to see how you view it overall. As you are aware, representatives of the Reserve Bank took part in a roundtable discussion on Australia’s financial institutions’ lending practices. We were encouraged by the level of subprime loans or non-conforming loans in Australia versus the US—one per cent to about 15 per cent. But I suppose our concern is: is this going to have any direct impact on the Australian market because of those who rely directly on the US market for borrowing, for those who have the packaged security loans that they have purchased and are supplying funding for, and then the flow-through to the economy? There are two final aspects of the events that occurred: is there a worldwide hook-up of reserve bank
governors to discuss the situation and to proceed ahead, and would you still have proceeded with a rate rise if you had known of the events that have occurred this week?

Mr Stevens—There are quite a few questions in there—which, I suppose, gives me a choice of which ones I try to answer! I will go firstly to the questions on the subprime mortgage situation in the United States. We can think about its effects on Australia in two dimensions. Firstly, there are Australian investors who have been lenders in the subprime market in the United States. The feature of this market has been that the funding has been supplied—and, therefore, the exposures are incurred—all over the world. That is why we are finding that funds, banks and others from Europe and right around the world—including some hedge funds in Australia—who have had exposure to this market have now borne a loss. One of the difficulties that financial markets are having in coping with all of this is that, as yet, probably not all the exposures have come to light because they are so dispersed. The fact that they are dispersed means that it is not fatal for large institutions but it does mean that there is quite a bit of uncertainty in terms of information at present. There are certainly Australian investors who through hedge funds have been affected, in terms of the returns they are earning, by the subprime developments.

A second linkage is the extent to which Australians have similar sorts of loans. You are quite correct that these sorts of loans are something like one per cent of the mortgage market, as opposed to 15 per cent or even higher in terms of the flows over recent years in the United States. It is also the case that the arrears rates on those sorts of loans here are probably half, at most, of what they are in the United States, and they are drifting higher but much more slowly. So it is a much smaller market with less trouble in that market.

It is the case that financial institutions who depend heavily on wholesale funding in international markets are being affected at present by the tightening credit conditions globally. I think it is the case that the major banks here are less dependent on that particular line of funding. They have more diversified funding, including onshore, so that is a relative advantage to them at present. The key question is how long these tighter conditions will persist. Nobody really knows the answer to that. I think that, the sooner the exposures to the underlying asset problem in the United States are all known, on the table and understood, the sooner the markets will be able to make a better assessment of the relative strengths of the various counter-parties they deal with and the sooner market functioning can get back to normal. I would be optimistic that that could happen reasonably quickly if the information becomes available.

Would we have increased the rate last week if we had known about this? Of course, you cannot really go back and remake decisions on the basis of information that was not available then. We could see that there were tensions in global markets to some extent. We did not think at that time that those things were likely to make a difference to the macroeconomic outlook sufficiently to outweigh what we thought was a pretty clear case for a modest adjustment to interest rates. I still think that.

Most likely, the global economy has pretty strong fundamentals. It is true that the US is weak, but other areas of the world have been accelerating over recent times, particularly China, which is very important to Australia. I do not have any reservations about last week’s decision. But these financial events obviously bear close watching over the period ahead, as I said in my talk.
CHAIR—I want to follow up on your comment about the fact that you are confident in the decision that you took last week. As you are aware, we have briefings from economists before we undertake these sessions. There have been some questions about the forecasting model that is used. Were past CPI projections aberrations? Is the model still appropriate in terms of making the forecasts?

Mr Stevens—We are not tied to any one particular statistical or econometric model, if that is what you are referring to. We have at least half-a-dozen models of inflation that I know of, and probably more. We run all of those. The forecast that we end up with is model informed but also heavily influenced by our judgement. Perhaps where this line of questioning takes us towards is the fact that it has been a little bit difficult to read what the current trend in inflation has been over recent quarters. As you will recall, last time we met we had had some trend towards a pick-up in inflation during 2006 and then we had one quarter of a softer figure. I said at the time that that was good news but it was not clear whether that was a new trend or just an aberration and we felt that the inflation episode was not yet complete. Subsequent to that, we got another low figure.

When you are analysing the run of data, you have a view in your mind about what should be happening, but you are open to the possibility that what is happening might be different to what you expect. As the run of figures comes in, you ask yourself the question of how much weight you should give to the alternative view that maybe inflation is a little bit lower than you thought. We began to give more weight to that as we continued to get unusually low figures. We did not give full weight to it. Had we done so, our forecast for the year ahead would have been much lower than it actually was, because the quarterly inflation rate was running at not much above two per cent. We did not bring the forecast down that far, but we did bring it down to some extent. Now we have just had, as you know, a higher number. We did not react to that in a knee-jerk fashion and say, ‘Because it’s running at 3.5 per cent on a quarterly basis that becomes the new forecast.’ We applied some judgement and scepticism to that. But it would have been pretty hard for anybody not to conclude that, if you have had slightly higher than expected inflation now and you have also had noticeably stronger demand growth in the economy for at least six months, the likelihood is that the inflation path in the future is going to be a bit higher than you thought. So we made an adjustment to our forecast accordingly, and then we responded to that at the meeting last week.

CHAIR—On page 2, you talk about the fact that the pace of growth and labour costs overall have remained relatively contained. In the past, you have talked about the flexibility of the wage-fixing system, which has assisted the resources sector during this boom. To what extent do you feel that the flexibility that exists has been a significant part of containing wages growth?

Mr Stevens—It has been very important. If you cast your mind back to previous episodes when we had a large terms of trade gain and therefore a big rise in the community’s income and a big rise in optimism, what tended to happen under the old system that we had was that labour cost gains extracted in the strong sectors where the market was telling you that wages should rise then tended to flow across to other parts of the economy through the centralised system and because of the idea that there had to be so-called comparative wage justice and so on.

The system we have today, which we have evolved over many years of gradual changes to labour market institutions, is one where there are big gains in wages in mining or some parts of
manufacturing and construction but very small wage gains are going on if you work in retailing or some parts of the hospitality industry. So a relative shift in labour costs is occurring just as the textbook says it should in a circumstance where you have had a shock to the economy which delivers big income gains via one sector. So, in the broad, qualitatively, the shift in relative wages that is occurring, I would say, makes sense from an economic point of view. The aggregate growth in labour costs—and we had a figure just a day or two ago—shows that it is still trundling along at about four in overall terms, which was quite a good outcome, given that those wage rises have not budged in aggregate for about three years, while the unemployment rate has kept falling. That is clearly, I think, a much more flexible labour market handling the shock much better than it would have 20, 30 or 40 years ago. I think that has been quite important.

Dr EMERSON—Governor, when we last met, I asked you about the June quarter CPI. It was in late July, ahead of your meeting in August. I pointed out that, as everyone knows, we are in an election year. My question was: if the economic circumstances suggested that an interest rate rise was warranted, would you hesitate in doing that in an election year? You responded by saying that you would not. In fact, you said that the answer to the question is: if it needs to be done in August, it will be done. It was done.

CHAIR—Was that due to you?

Dr EMERSON—I think the governor should take responsibility for the interest rate increase! The obvious follow-on question is that, given the next CPI figure will be out in late October—the Reserve Bank will meet on, I think, 6 November—and we are getting closer to an election, if the economic circumstances warranted it and given that you have an underlying inflation forecast at the top of the range at three per cent, would the likelihood of that being very close to an election deter you from adjusting interest rates or would you not be so disposed to adjust interest rates in an election campaign?

Mr Stevens—I thought you might ask that question.

Dr EMERSON—I thought that you thought I might ask that question too.

Mr Stevens—I think that the only answer I can give is: if it is clear that something needs to be done, I do not know what explanation we could offer the Australian public for not doing it, regardless of when the election might be due. I do not think that there is any case for the Reserve Bank board to cease doing its work for a month, in the month that the election is going to be. I doubt very much that members of the public would regard that as appropriate. So, should that data, or other data for that matter, make a clear case, I feel we have no choice; nor should we have any choice.

Dr EMERSON—My next question relates to that inflation forecast. The three per cent underlying forecast was reaffirmed in your statement today, as it was in the Statement on monetary policy after the decision of the Reserve Bank the other day. You said again in the discussion a moment ago that last time we met you felt that the inflation episode was not yet complete. Given that we are looking at a forecast for the underlying rate after the August rate rise of three per cent, do you think the inflation episode is now complete or do you think that there are circumstances that could warrant further adjustment to monetary policy? If I could just
put that very briefly in the context of a decision that was made on 3 May 2006 to increase interest rates by 25 basis points. In the February statement the bank was talking about an expectation of an underlying inflation rate increasing to 2⅓ per cent, and that actually led to the Reserve Bank increasing interest rates. It is against that background that we are now looking at a three per cent forecast. How do you think that will all play out? Is the inflation episode now complete or are there still significant risks of ongoing inflation beyond the acceptable range?

Mr Stevens—if you face an economy in our circumstances, we are clearly very fully employed. We are getting a stimulus from the rest of the world which is quite powerful and which is, I would say, beyond in some sense the normal cyclical ups and downs of our terms of trade. So there is quite a big set of forces at work there. I think you would have to be feeling that, in that world, you have got to be on the look-out for inflationary pressures. So, if that is the world we face and that is the world we are assumingly facing in putting these forecasts together, we are at a point where we are certainly more worried about inflation being too high than we would be about growth being too low.

The question I suppose that will occupy many people, including us, over the period ahead, is whether these global capital market developments are going to change that global outlook in some tangible way such that the balance of risk starts to change. It is conceivable that that could occur. I think it is too early to know as yet. We are not inclined at the moment to rush in with another set of forecasts because of a week’s volatility in financial markets. It is quite possible that a lot of that volatility will calm down very quickly, but it may not. If tighter credit conditions continue and get broader internationally, it is quite conceivable that that will have an impact on the major countries and therefore the global outlook and, in due course, us. It is too early to know yet. That is a factor that could be at work in the period ahead. But, absent that, the story as I said is that there is an economy that has got a lot of momentum. It is very fully employed. It is enjoying—if that is the word—substantial external stimulus, and inflation has gone up a bit over the past couple of years; our job is to be alert to that and to try to make sure we have got a setting in place that resists those pressures.

Dr Emerson—Just a quick follow-up on the chair’s question about flexible labour markets: you referred to previous periods when the terms of trade were very high. There was such a period in the late seventies, early eighties where there was a centralised wage fixing system. Are you aware of any proposals to return to a centralised wage fixing system?

Mr Stevens—I am aware that there is political debate about various policies that are on offer at the forthcoming election about industrial relations. I am unable to judge, I suppose, the extent to which recentralisation might occur, to be honest. And I do not think I really want to step into the political realm quite so soon if I can avoid it.

Chair—Thank you for an excellent answer, Governor. I will now ask Steven Ciobo, whose electorate we are in at the moment, whether he has any questions. I also thank him for encouraging this committee to come to the Gold Coast to undertake this questioning.

Mr Ciobo—Welcome to Queensland, Governor. It is good to have you here.

Mr Stevens—Thank you.
Mr CIOBO—I apologise for the weather. We try to do better on the Gold Coast, but I see dark clouds are around us.

Mr Stevens—It is a fair bit warmer than Sydney was yesterday.

Mr CIOBO—I have a couple of questions—some general, and then a couple that are more specific. In your opening statement, you made comments regarding traded and non-tradeable goods. You said, among other things:

Some of the resulting demand spills abroad, but there is also a stimulus to spending on non-tradeable goods and services arising from the income gains being experienced.

I am interested to know your views with respect to inflation rates in both the traded goods and non-traded goods sectors. My understanding is that, over the past several years, we have seen traded goods showing inflationary impacts and non-traded goods not really showing any real spikes or great growth. I am interested in your comments. Given that the spikes would appear to be with respect to traded goods, why would that put upward pressure on interest rates?

Mr Stevens—Traded goods prices really have two components. One is what is happening at the source in terms of the currency of the country that is supplying. The other component is, of course, what happens to the exchange rate through time. There have been some fluctuations in tradeable goods prices. The other thing that happens here is that I think oil or petrol is regarded as a tradeable, so fluctuations there also come in and that can complicate extracting the longer term trend. But tradeables prices have tended to speed up a bit in the past year. Non-tradeables prices have actually come down a little since 2003, though I think that with a very tight domestic economy that is probably the area where we see the risk of some possible acceleration over the year or two ahead. The tradeables story in the period ahead? Well, a week ago, we would have said that the higher exchange rate this year might put some downward pressure there. Of course, the exchange rate has changed a lot in the past week, so there is some question there. But exchange rates go up and down, and at the moment they are a bit unstable, so it probably does not do to draw too many strong conclusions there. Ultimately, I think we need to be wary that non-tradeable inflation does not pick up too much speed. It is the part that tends to have inertia and momentum. Once it gets going, it is hard to stop. I would say that, by the same token, if you can keep it well anchored, then you are probably going to be okay over time.

Mr CIOBO—So, to get this right, what I am hearing from you is that, in terms of non-traded goods, the inflation rate has actually fallen in the past couple of years. I take it then that Reserve Bank movements and tightening of monetary policy is either a response to inflation in traded goods and/or a concern about non-traded goods inflation, which has been falling for several years, possibly starting to increase. Is that correct?

Mr Stevens—We typically do not make strong responses to short-term fluctuations in tradeable goods prices that are driven by the exchange rate, because exchange rates can reverse course. Often those things do not disturb inflation expectations and the longer term trend in prices. The tightening of policy that has been going on over some time now—including the one last week, but also the ones before—is basically predicated on the notion that the economy has been approaching full capacity. When you do that, you have less scope for rapid demand growth
and more likelihood of inflation pressures. We need to be active in responding to that. That is the general story.

Mr CIOBO—Those inflationary pressures would be played out in the index of traded goods, wouldn’t they?

Mr Stevens—They can come from either source but—

Mr CIOBO—Non-traded goods, I should say.

Mr Stevens—the thing to be most concerned about in the long term is keeping non-traded prices on track. If we can do that, then I think the inflation outlook over the long term will be fairly secure.

Mr CIOBO—The impression I get, based on comments you made this morning, is that perhaps the single greatest influence and impact on inflation in Australia is coming from external stimuli—that is, factors outside of Australia. Coupled with your comments that, when it comes to non-traded goods, inflation has reduced over the past couple of years, is it fair to conclude therefore that upward pressure on the inflation rate is predominantly coming from external stimuli?

Mr Stevens—I think what is fair to conclude is that the external stimulus on the economy, which affects economic activity and demand because it affects incomes therefore it affects spending generally, is a very powerful force. If that force were not there, then I think the economy would look quite different and quite possibly monetary policy would be doing something different as well. I do not think there is any doubt that these external forces are very important in the way things are evolving. You are talking about a five-decade high in the terms of trade. There has been a rise in the terms of trade of 40 per cent over four years—that is eight per cent of GDP of extra income. We do not get all of that; foreign shareholders as part of the mining sector get some of it, but we keep a lot of it here. Not surprisingly, incomes are going higher and people are optimistic. They are spending and that is expansionary and it potentially puts pressure on prices across the board. That is the thing that we should be responsive to.

Mr CIOBO—One of the other key issues you have raised is labour. You say that job vacancies are high and surveys suggest that many firms see the difficulty of finding additional labourers among the biggest or the biggest impediment to expanding production. As yet though the pace of growth and labour costs overall has remained relatively contained. Despite Dr Emerson’s attempts to inoculate the debate in terms of labour market reform, I seek your comments on a couple of things. I notice that the general trend has seen public service wage growth rising much more quickly than the private sector. I would be interested in your comments on the likely impact should that trend continue, especially where it is not coupled with productivity increases, as well as a more general comment about the impact of wage rises that are not linked to productivity gains but flow from a more centralised fixed wages system.

Mr Stevens—It is true that public sector wages have been rising faster in the wage price index than private sector wages in recent times. That of course is not always true through history; it tends to wax and wane. My view on things like that is that, ultimately, there is one labour market and a tight labour market. The public sector in its own way is in the same market as the private
sector, often needing the same skills and it is subject to the same pressures to find people. I do not place great store on the distinction between public and private; we tend to just look at the total. It is axiomatic that wage gains not backed by productivity in any sector put pressure on either prices or profit margins depending on to what extent the enterprise concerned is able to pass them onto their customers. You cannot always assume they will be, of course, because product markets are very competitive, so excessive wage gains not matched by productivity could end up damaging profits and therefore the company and employment or it could end up going into prices. It just depends on the demand conditions you face at the time.

Mr CIOBO—Finally—

CHAIR—Whilst there is a certain amount of latitude with this being your electorate, can I just encourage members to restrict themselves to three questions? Can it wait till the next round?

Ms GRIERSON—Mr Stevens, my two colleagues have both tried to press you on an important issue to the Australian people—that is, our labour market and the behaviour of wages. In an earlier statement you said today that those labour market reforms have been in place for over 15 years. I interpret that as the governor saying to us that there is a bipartisan pattern of commitment to labour market reforms and therefore no indication of any return to any centralised wage fixing. From that comment that you made earlier about the last 15 years, would you agree that much of the progress in the country on reducing wage price inflation has occurred through the accord and then the move to firm level enterprise bargaining? And do you see that continuing, no matter what the outcome of the election is?

Mr Stevens—My view is that the Australian labour market is very different from the animal we saw in the episode that Dr Emerson referred to in the late seventies and early eighties. I think it is obvious that two successive governments of differing political persuasions have moved things in the direction of less centralisation, more flexibility, more focus on productivity and so on. I do not think an objective observer would conclude differently. What is currently being debated in the political sphere is the extent to which very recent changes get reversed and what impact that may have, but I do not really want to weigh into that political discussion.

Ms GRIERSON—Governor, it has been suggested that the Reserve Bank of Australia provides less information regarding its thinking and its predictions than perhaps some other central banks. Does the business survey give indications of business investment into productivity growth—and Mr Ciobo also raised productivity—and into new technology? Does it give indications of their involvement with the labour market? What information does it give you and why can you not make it available to us?

Mr Stevens—Which survey are you referring to?

Ms GRIERSON—I know you do a business survey as part of your predictions.

Mr Stevens—Perhaps you mean the liaison work that we undertake every month.

Ms GRIERSON—Perhaps I do.
Mr Stevens—I suppose you could call that a survey. It is not that the information which we glean from that is terribly secret; it is actually littered through the documents, because it informs the judgments that we make. I will get Malcolm to say a bit more about the liaison program and what it tells us about investment.

Ms GRIERSON—In particular, is it informing productivity investments by business or does it help you to understand if there are those commitments into improving productivity by business?

Dr Edye—We talk to businesses about the whole range of their operations. Basically, our program tries to cover the whole economy, and we talk to businesses on a basis that represents the industry structure of the economy. We are meeting about 100 businesses a month and all of that material gets fed into our internal reports about the progress of the economy. The sorts of things we ask businesses depend on what part of the economy they are in but we ask them, for example, how strong demand is for their products, what their investment plans look like, what is happening to their prices and wage pressures in their industry and so on. So we get feedback on all of those things, and the general sense that we are currently getting is that demand for product is strong and that businesses’ investment intentions are also strong.

Ms GRIERSON—Do you expect that the current market volatility may impact negatively on that? Can you gauge that in any way?

Mr Stevens—At the moment, the financial market volatility we are seeing is impacting most directly on financial institutions. I do not think it has had any great effects on your average, everyday business. It is true that the share market has been volatile but share prices are still historically pretty high. I doubt that we are likely to see a big impact on the confidence of mainstream businesses from this financial volatility in the near term. The longer term risk would be if there were a serious tightening of credit conditions globally that then led to a withdrawal of credit provision in the real economy. I do not think that is happening at the moment. Clearly, that is a risk one has to be on the alert for, and we are. But I doubt very much that as yet anything that has happened on money markets, foreign exchange markets or even share markets is going to seriously dent the real fundamentals for mainstream businesses, which are very good.

Mr SOMLYAY—Governor, you might remember—this may be ancient history—back in Warrnambool in 2002 I put a question to the governor regarding the impact of state government deficit budgets on inflation. He did not seem concerned that there would be any, but then, last year, the previous governor stated that fiscal policy had not really been a concern to him up until then, but it now might be because the states are part of the equation. Since then the fiscal stimulus from state governments has been quite large and, over the coming year, that fiscal stimulus is expected to expand by around $70 billion. My question to you is: if the Commonwealth were suddenly to embark on a spending spree, with deficits adding up to $70 billion over four years, would you see that having a zero inflationary effect or a likely inflationary effect?

Mr Stevens—I was not at the hearing in Warrnambool. It is one of the few that I have missed. Regarding the $70 billion you quote, my understanding is that it is actually the cost over a number of years—not a single year.
Mr SOMLYAY—I said ‘over four years’.

Mr Stevens—Okay, it is over four years. On the question of what public sector activities are doing to the economy, we have to keep in mind that demand is strong almost everywhere, except in housing construction. Every other sector of demand is strong—private sector. It is true that at the state government level a big build-up in infrastructure spending is planned. The economic impacts of a government business enterprise building some piece of infrastructure are not really any different to the economic impacts of a private company doing the same thing. They add to demand and it is quite apparent now that infrastructure needs to be expanded. Ideally this would have been done five years ago when the miners did not want to do it at the same time, but it was not. It still has to be done and, yes, that is a factor at work in the economy along with very strong private demand and along with the large foreign stimuli that we talked about. So there are a lot of things that are basically giving us quite a strong demand picture. Those infrastructure spend things are one, but only one among a number.

Mr SOMLYAY—Because it takes so long to complete these infrastructure projects, we do not see any productivity gain for maybe four, five, six or 10 years. Will that have an inflationary effect, if we have the spending without the productivity gains?

Mr Stevens—if the spending is putting in place genuine infrastructure, that does two things. It adds to demand in the short term, but it also adds to supply in the long term. Without wanting to endorse or otherwise particular projects, I think it is reasonably clear that we need more supply of infrastructure over time for the economy to grow; otherwise we will be capacity constrained permanently. So it is a matter of putting in place that longer term supply capacity and trying to manage the short-term impact of that on demand so that we do not kind of blow up inflation on the way through. If we can manage that then the economy has good growth prospects in the medium term because of the additional supply capacity that has been put in place. We will see that. I think, coming to fruition in the next couple of years in the mineral sector, where there are big capacity expansions currently being done and starting to come on stream. Our ability to supply exports is going to improve. GDP will go up, but so will potential GDP, to the same extent, because it is a supply driven expansion. That is really what we need in some of these other areas as well.

Mr SOMLYAY—Chris Richardson from Access says he believes the current state government spending levels are inflationary. Do you agree?

Mr Stevens—Compared with what? More spending by someone, somewhere, all other things being equal, puts more pressure on demand and therefore on the economy’s available capacity. But I think you could equally say that spending by the mining sector on what they are doing is inflationary, or spending by consumers on goods and services. There is a lot of spending. I do not think it is necessarily the way to go to single out particular chunks and say, ‘This is inflationary, but all these other things aren’t.’ It is the total that counts.

Mr TANNER—First, along with almost everybody else, I have a labour market question. My recollection is that at the hearing in Perth in February this issue of a purported return to a centralised wage-fixing system was floated and you made very similar comments to those that you made today and that, during the course of that dialogue, you indicated that to the best of
your knowledge there were no proposals to return to a pre early 1990s centralised wage-fixing system. Is that still the case, in your view, today?

**Mr Stevens**—You are probably in a better position than I am to determine what degree of recentralisation might be proposed.

**Mr CIOBO**—The governor’s hesitancy should be noted!

**Mr Stevens**—Look, I do not want to step into this particular political minefield. The main point is that, whoever is in government, a flexible labour market works very well, and it is very important to keep that. I think everybody knows that.

**Mr TANNER**—A topic of discussion at these hearings for probably a couple of years now has been the problem of capacity constraints. The first part of this question—I will separate them so that you do not have to deal with them immediately in sequence—is: in your view, has there been any significant amelioration in the problem of skills shortages in recent times from the point of view of the supply side with respect to skills shortages? Secondly, how important has the very substantial increase in immigration levels in recent times been in relieving pressure both on skills shortages and on the demand pressures putting upward pressure on inflation and interest rates?

**Mr Stevens**—I wonder whether those things are not in a way the same question. As far as I know, our liaison work still tells us that people find labour hard to get. As I said in my opening remarks, in some surveys it is the single most constraining factor on a further expansion in their activities. As far as I know, I think immigration probably has been helpful in recent times in, at least to some extent, making these problems of shortages less than they would have been. It has made quite a substantial contribution to the growth in employment, for example. I might get Malcolm to run you through the detail there, if you like. So I think immigration has been important. Of course, it is always important to also keep in mind that immigrants eat, need to live somewhere, drive a car and so on. They add to supply. If you can move the supply to particular pockets of shortage that is good, but they do add to demand as well. So those things need to be kept in mind. Malcolm, do you want to add something to that?

**Dr Edey**—We have had significantly above trend growth in employment for the last couple of years, and we included some figuring in our quarterly statement just recently showing where that comes from. It can come from an increase in the working age population above what would normally occur, which is basically driven by immigration, or from higher labour force participation or from reductions in unemployment. Roughly speaking, we are getting about a third of it from each of those sources. So it comes from higher skilled migration; increased participation, particularly amongst older workers—older males are staying in the labour force longer; and from drawing people out of the existing pool of unemployed.

**Mr TANNER**—I have a final question on the capacity issue and on infrastructure more broadly. Given your observations with respect to the investment in infrastructure that is planned by the states—with the caveat of course that you obviously cannot endorse or not endorse any particular proposed project—and the fact that these infrastructure investments have both a demand side impact and a supply side impact, is there any case for the states winding back or diminishing their macro plans for further infrastructure investment? Associated with that, to
what extent do you believe Australia’s relatively poor performance in the availability of high-speed broadband, compared with other advanced countries like the United States, has an impact on things like productivity?

Mr Stevens—On the question of whether the states should wind back, my sense is that, if they find that that the projects cannot be completed at reasonable cost, they will wind back. In conversations I have had with a couple of the state treasurers, they seem to be saying that, at the moment, they are not finding things too hard to complete, but, if they do—if the prices tend to move away from them—they just delay until things calm down. I think that is a very sensible way to proceed. So I think they will be able to make that call themselves if they have a good sense of how the costs of the projects are moving. As to the broadband question, I am not really in a position to make an informed comment about the extent to which broadband availability here, relative to the US, has any impact on productivity. I am not expert enough in that area. I would simply make the observation that, for much of the past 15 years, our productivity growth was as good as theirs. Recently, though, ours has slowed and so has theirs. There are things going on which presumably relate to things other than broadband, so I cannot really give you an informed opinion on that.

Mr McArthur—I raise the matter of the use of interest rates as an instrument of Reserve Bank policy, given that interest rates become an immediate factor in households and business and also given the fact that petrol, fruit and vegetable prices have risen quite dramatically. What do you say to some of the commentators who suggest that the use of interest rates is a fairly blunt instrument in controlling inflation?

Mr Stevens—To some extent it is a blunt instrument. However, it is the instrument we have; it is the one that works. Most of the ideas that one sees for other ways of doing things tend to end up saying: ‘Just don’t tighten monetary policy.’ What history shows is that, if you have inflation pressure, you have to act against that with monetary policy, and the way central banks everywhere do that is by raising the rate of interest. It is true that that tightens up people’s budgets. That is the idea; that is how it works. We are not pretending that there is no pain involved. The idea is to constrain spending, relative to supply, and dampen the pressure on prices. We have had a lot of these debates over the past. If you go back to the long-distant past, when I first joined the Reserve Bank, there used to be the idea that you could control how much banks lent—you regulated all their interest rates, you had reserve requirements and all those things. Basically, that system did not work very well. It actually failed to contain inflation for 20 years. Through the 1970s and going into the eighties, inflation remained quite high. The system that does work—and this is shown all around the world—is that the central bank moves the short-term interest rate up and down and that affects the cost structure for borrowing, and that affects demand, and that affects inflation with the lag. That works. To my knowledge, nobody has found a system that works better, so that is the one that we stick with.

Mr McArthur—You mentioned the problem of the market assessing risks. The private equity market has been of interest to this committee. What is your view on the activities of private equity investors, given the volatility of recent times and your comment on the risk aspect of it?
Mr Stevens—The world has changed quite a bit for the private equity community. Ric, you might like to give a bit more detail about that because you have been on the record on this in the past and it might make sense for you to add a bit.

Mr Battellino—When people talk about private equity, there are usually two types of financing that people have in mind. One is mezzanine financing, where finance companies are helping small or start-up companies to develop, and that has had a long history and continues, but it is a very small part of the market. The thing that got the attention last year was the other side of private equity, which is the leveraged buyout activity. It was certainly the case here that we had a very large increase in that sort of activity, but that was a global event; every country had it. What happened here was just a very small part of what was happening globally. What drove that was the very unusual conditions in capital markets, in the sense that the cost of debt was very low and the return on equity was very high, and that created an environment where it made sense to repay equity and take on debt. So it is not surprising that we saw those activities last year. Having said that, I think that game is over. Those companies cannot finance the debt anymore. Basically, that activity is slowing right down again, I think. I do not think it is something that is going to cause a huge problem for the economy. It is something that happened last year and it has basically died down again. We have seen the same thing. If you go back to the late eighties, there was some financial innovation, where people designed the so-called junk bonds. That caused a huge increase in LBO activity for a year or two. Again, that ran its course eventually.

Mr McARTHUR—Mr Stevens, my final question is in relation to the deregulated labour market and the effect on the commodities boom, which you have alluded to. Previous governors have alluded to the fact that the deregulated labour market has stopped the flow-on of wages. Do you think the isolation from economic activity that mining companies in Western Australia and Central Queensland experience, as well as the policy setting, would be a factor?

Mr Stevens—if I understand the question, it is: does the physical isolation help contain the pressures? It may do, though my understanding is that, with a lot of these mining companies these days, people fly in from somewhere else, work for a period and fly home. What the companies are doing is tapping into the national labour market. So there may be some pockets where physical isolation helps to contain things. But my guess is that in the Australian community and labour market people are pretty mobile. They will move physically in response to the incentives on offer. These companies are basically utilising the national labour market. It is the industry-specific or most probably the firm-specific conditions which determine their wages. The separation, in a sense, happens at that level rather than in a physical way.

Mr McARTHUR—if we were to move back to a more centralised system, might the flexibility go out of those sets of arrangements?

Mr Stevens—the centralised system that we had was characterised by strong notions of comparative justice. I think that system would not handle the current circumstances at all well. The question is: is anybody actually proposing that system?

Mr KEENAN—I, too, want to raise the issue of labour market flexibility, but, unlike some members of the committee, I will not be asking you to illuminate my party’s policy on that. Does the RBA conduct any modelling on the effects of labour market flexibility?
Mr Stevens—I am not sure that I know the answer to that. Malcolm, do we?

Dr Edey—We had a research paper earlier this year that looked at some of those issues in a very general way, over a long period of time. It showed that the general trend towards increased flexibility has been one factor that has contributed to productivity growth, along with other things like increased product market flexibility. That sort of study is quite consistent with the sorts of results that come out of OECD studies, for example. I do not think anybody would find that particularly surprising. We have not tried to pin down the effects that might come from any particular element of the labour market changes that have occurred over a 15- or 20-year period. I think that is a much more difficult exercise and almost impossible to quantify.

Mr KEENAN—Thank you for that, because the economic consultancy firm Econtech have modelled what would happen if labour market flexibility were eliminated from the system. They have said that, by 2011, if the reforms of this government were reversed and the reforms of the last government were also reversed, real GDP would be about 4.8 per cent lower, which accounts for about $2,700 per Australian. It would also result in the loss of 316,000 jobs. This higher unemployment would obviously lead to wage inflation and feed into interest rates, and they modelled that interest rates would be about 1.4 per cent higher than what they would be if the current reforms were kept in place. Would you care to comment on that?

Mr Stevens—I do not propose to comment in any detail on those model simulations. I make two observations. Firstly, I think most people agree that, if you remove labour market flexibility as a general idea, that is productivity disenhancing and welfare disenhancing for the aggregate economy. There is no question that that is true. As for what would happen to interest rates, in the long run we will achieve the inflation target, which means the nominal interest rates will be about where they normally are. Changes in labour market arrangements over a long horizon are much more likely to show up in the unemployment rate than in the inflation rate. We will achieve the inflation target and, if we do, I would expect nominal interest rates to be in the range that they have been since inflation has been at these levels. It is certainly true that, if there is some shock to the labour market that pushes wages or prices away from target, we have to respond to that. But in the long run monetary policy will anchor inflation at two to three per cent, and the nominal rates of interest we see will be in accordance with that.

Mr KEENAN—So a deregulated labour market will help you reach your inflation target?

Mr Stevens—Fundamentally, in the long run, a deregulated labour market I think gives you a lower rate of unemployment. I think it is not actually helpful to think about labour market regulations in terms of their effects on interest rates. What the debate should be about is the effects of given sets of labour market regulations on the rate of unemployment. The central bank is responsible for price stability in the long term; labour market arrangements will determine the rate of unemployment that goes with price stability.

CHAIR—There was a question you wanted to ask before, Mr Ciobo.

Mr CIOBO—That question has been asked, but I will ask a question that has now arisen. Governor, I am trying to understand your comments. I am not having a go at policy when I say this, in terms of any policies that are on the table, but the simple extrapolation of your statement...
is that a less flexible, more centralised system will result in a higher unemployment rate than a more flexible, less centralised system.

Mr Stevens—As a general proposition, I think that is right. I would not have thought there was much disagreement with that anywhere.

Ms GRIERSON—Governor, I take the comments you made in response to Mr Keenan’s question, which I think was a strong statement of the independence of the Reserve Bank and the way interest rates will be applied strictly to monetary policy, as a commitment that interest rates are the province of the Reserve Bank and, given your predecessor’s comments that there was bipartisan support for monetary policy and the fiscal framework that supports it, that it therefore would not be plausible to claim that interest rates would be higher or lower under any particular political party.

Mr Stevens—My statement is a statement of long run tendencies. Our job is to anchor inflation at two to three per cent. I think both sides of politics agree with that. We are independent to do that. If we are successful in doing that, the nominal interest rate would be driven by that. Frankly, if you want much lower interest rates in the long run, choose a lower inflation target. To get there you have to raise them to drive inflation down, then they go down. In the very long run, the nominal interest rate goes with the inflation target. I suspect that the various comments made about what interest rates would do under this or that particular policy are about transitional periods, and about what response some particular policy in some area might cause from monetary policy because of its impact on inflation. I have no comment on that but, as a long run proposition, the rate of interest goes with the rate of inflation.

CHAIR—Before we break for morning tea, we ask students to come forward. Welcome.

Joseph—I am from Elanora High. Can you see the Reserve Bank playing a bigger role in monetary policy in the future when today’s students step into the workforce?

Mr Stevens—Thank you, Joseph. Monetary policy, I expect, will continue to operate in the way it has over recent years. I think that those people of your age coming into the workforce in the years ahead in fact come in at great time. It is a great time to be entering the workforce because this is an economy more likely to be short of workers than to have too many and that is in your interests, because you will be scarce and people will be working hard to acquire your services. Good luck to you. It was not like that when I joined the workforce.

Alison—I am from Canterbury College. What processes are the RBA able to implement to dampen the impact of the current housing crisis and the lack of affordable housing?

Mr Stevens—Thank you, Alison. That is a question I am surprised the committee has not asked yet, but they were probably getting to it. At a very general level, the best thing that we can do is keep inflation rates controlled, because if we do not do that then interest rates will end up much higher than otherwise. I think the biggest problem for housing affordability is that basically, particularly if you are a first home buyer, the level of house prices is too high. The policies to address that are mainly not in our preserve, except that, if we run monetary policy too loose, house prices tend to inflate more than they need to and that would not be good. Our main job is to keep inflation controlled.
Scott—I am from Nerang High School. What are some of the main factors that you think about when you raise the interest rate?

Mr Stevens—The main factors are: what do we need to do to contain inflation in the economy over time? When we raise rates, what is happening there is that we have made a decision that policy needs to restrain spending in the economy in order to take some pressure off prices. That is probably the main factor. We look at a whole lot of data to come to that judgement. You would not believe the volume of it. But, in the end, that is the judgement we make—that we need to restrain spending to keep pressure off prices.

CHAIR—This is a second question, is it? Okay, but briefly.

Chantara—I am from Nerang too. It will be brief. I am from Nerang high. When the Australian dollar rises and then has a rapid fall like it did in the stock market yesterday, what is and who are some of the people affected by this?

Mr Stevens—The exchange rate affects people who are in the traded part of the economy—exporters and importers. It also affects people who are shifting capital, money, across national borders. A big change in the exchange rate on any particular day is not going to affect any of us all that much tonight. If it moves a long way and stays there then that affects prices either up or down and exports and imports over time.

CHAIR—Thanks very much, guys—good questions. We will have a break for morning tea.

Proceedings suspended from 11.31 am to 11.52 am

CHAIR—We will resume the hearing. Governor, I understand there was an intervention last night by the Reserve Bank in the foreign currency market due to the volatility that exists at the moment. Is this likely to be a continuing situation?

Mr Stevens—It is true that during the overnight session, in rather thin disorderly markets, we did a bit of dealing; a small quantity. We do not typically signal intentions about interventions ahead of time, for obvious reasons, so I prefer not to speculate about the future. The general point is simply that on occasion, where market conditions are disorderly, we are prepared to intervene from time to time if that is a useful thing to do, which it seems to have been on this particular occasion. There is not really anything more that I can add.

CHAIR—I also posed a question last time—I do not know whether you were deliberately avoiding the question—about the international tie-up with central banks around the world. Is this a feature of what happens at times like this?

Mr Stevens—Our people in the dealing rooms that we have in London, New York and Sydney are in touch with both private market participants and other central banks—the central banks in this region on a daily basis. It is quite a routine thing to exchange information on what is happening. That is quite a normal thing, and I am sure it will be taking place probably with a bit more intensity at the moment than normal. I have been party to some discussions with some foreign counterparts in the past week or so just to hear what is going on, but there isn’t any kind
of coordinated activity that I am aware of amongst the central banks; there is just routine information sharing, which is very helpful.

**CHAIR**—Stewart asked a question about the impact of the interest rates, and about blunt instruments. In our briefing yesterday there was a suggestion that after the interest rate was increased earlier in the year we still had consumer prices moving through and consumer spending continuing at a reasonable clip. What is the length of the lag these days for it to flow through into the economy and to start to restrain spending? What is the timeframe?

**Mr Stevens**—It has always been thought that the lags can be fairly long. There is an initial confidence impact that is very quick, at least on some occasions. You typically see, and we did this time as well, the index of consumer confidence constructed by Westpac Bank and the Melbourne Institute going down very sharply just after a rate move. It tends to bounce back again pretty quickly. There is a confidence effect. If you think about a change in interest rates today, the time from that moment until the last worker produces the last consumer durable that is put in the last house that is built or not built because rates changed today is quite long. It is probably three years away. In the interim, the effect builds. Typically, the econometrics used to be that the mean lag—that is, when you get half the total effect—was about a year and a half, and the rest of it keeps coming more gradually after that. It does take time. Of course, that is important because in evaluating whether we have the level correct we have to keep in mind what we have already done and that what we are doing now has effects that last some time into the future. Lags can be long and most of the time they are long.

**CHAIR**—My final question relates to the two-speed economy. We have had questions on that before: Western Australia and Queensland versus the eastern states. There are also two speeds in the housing market even within cities such as Sydney, where we have one sector which is moving ahead reasonably fast and the other actually sliding in terms of prices. To what extent do you see that we have those dimensions going on within the economy at the moment?

**Mr Stevens**—We do have some differences by region as a result of the nature of the forces at work. As everyone knows, the resource sector is a bigger part of the economy here in Queensland and in WA. Not surprisingly, demand growth, spending growth and so on, is stronger typically in these times in those two states. One feature of the state-by-state divergences which has changed a bit since we talked about this before is that New South Wales has tended to pick up some momentum over the past little while. Possibly due to the fact that there was an election in New South Wales earlier in the year, there was quite a lot of talk about it being in recession. It never was. It was weak—weaker than the other parts of the country—but it has picked up a bit of speed in recent times. So that degree of divergence has diminished a bit.

The point you made about house prices is quite true. Within the city of Sydney there have been quite distinct differences in the way house prices have behaved. In the western suburbs of Sydney, prices have fallen quite appreciably over the last couple of years; in the wealthier areas in the east, they are probably firming again now. So there is quite a difference there. There are differences, to some extent, within a couple of the other cities. Of course, the housing market in Perth, which rose very rapidly over the last couple of years, on the data at least has reached a plateau over recent times and not a lot is happening there—at a very high level; it is roughly at the same level as Sydney. So there are differences across regions and within cities in housing markets; that is certainly quite true. Some degree of difference, of course, is pretty normal really.
CHAIR—I think your predecessor expressed concern about the cost of subdivisions and state charges in terms of the development of new estates et cetera. Do you still share that concern?

Mr Stevens—In this debate about housing costs it seems to me that, firstly, we should be clear which problem we are addressing. If your question is about the difficulty of potential first home buyers accessing the market, the question is why the bottom-end houses are potentially too expensive for those people. I think there is a question as to whether the cost of the marginal addition to the stock of dwellings is higher than it has to be. That, I think, is where these questions of zoning rules and loading onto the homeowner the costs of infrastructure and so on are relevant. I think they are important questions. I do not profess to be an expert about that stuff but it would seem to me that there are some questions to be answered there.

If you are talking about house prices in general, what we are talking about is why the existing eight million houses have been going up in price—and that is not entirely unrelated to the zoning type things, but it is more to do with a finite supply of well-located land. People have become more affluent, their borrowing power has increased and they have sought to enjoy a better standard of housing. In the process, because the supply is finite—indeed, the supply of the really well-located stuff is fixed—the price has risen. So there are several different dimensions, depending on which group you want to focus on.

Dr Emerson—Nominal interest rates have come down in advanced countries around the world, including Australia, over the last couple of decades. There have been a lot of structural changes to the world economy and the Australian economy. Could you briefly outline the beneficial structural changes that have helped economic policy making and your job? Do those changes mean that in today’s economy here in Australia, like other countries, we are unlikely to see the kinds of interest rates that prevailed in the 1980s?

Mr Stevens—It is certainly true that, in a wide range of countries, nominal interest rates came down, mainly because the high inflation of the seventies was sorted out. Here, they came down later than in most other countries, for the reason that we took longer to sort out inflation than did a number of the other advanced economies. If you are talking about long sweeps of time, the principal thing that drives nominal rates is the size of the inflation premium which has to be built into them for the ongoing inflation rate and, if you change that from eight per cent to 2½ per cent, as we have, then there is a big change in nominal interest rates. You also have real interest rate changes that can occur which, typically, would be more driven by real side things in the economy, to do with productivity growth and those sorts of things that drive the economy’s potential growth rate. An economy such as Australia probably has a higher natural real interest rate than an economy such as Japan, which has much poorer growth prospects than we do. That is actually a good thing, not a bad thing.

With respect to structural changes, I guess you are referring here to the wide range of reforms to product markets, labour markets and financial markets. In the main, I would say that the changes to product and labour markets make the economy’s pricing behaviour less likely to be disrupted by a temporary shock to demand, which makes our job easier in the sense that we have more time to respond to those shocks. They might be temporary, they might go away, so we might have to do nothing, particularly if there is not a big price response to those fluctuations and especially if inflation expectations are well anchored, which is one of monetary policy’s main jobs. All those things have been quite helpful.
Financial market liberalisation, in the main, is helpful. It was critical to float the currency to sell government debt at market rates. All those things are things you have to have if you are going to maintain proper monetary control. We did not really have all that until the mid-eighties and policy has been able to exert much better control over things since then. On the other hand, on occasion, financial market behaviour can lead to complications, as we know. In some ways, it is a slightly mixed blessing but, on the whole, those big reforms on interest rates and exchange rates were a key thing. Most important for controlling inflation is an inflation focused central bank, independent, dedicated to that job—ultimately, that is the key to maintaining price stability over the long run. Those other things are important, it makes the job easier from day to day, but, from where I am sitting, that fundamental structure in the Reserve Bank being geared to this task and being independent is critical.

Dr EMERSON—Given your job and your long history in the bank, could you envisage a return to very high interest rates in the future or would these structural changes and the independence of the Reserve Bank put a real restraint on future interest rate rises through the restraint on inflation?

Mr Stevens—Which interest rates? With respect to very high rates that characterised the high inflation era, I think it would be unusual for us to anticipate that recurring if we feel we had a good inflation control mechanism in place and, obviously, I think we do. That being so, if inflation is well controlled then, as I said earlier, nominal interest rates go up and down but their average level is calibrated to what the average inflation rate is.

Dr EMERSON—In terms of the shake-out that is now going on, you do not seem, in your tone, overly anxious about it. Obviously you are vigilant but you do not seem hot and sweaty and desperately worried. I know you went for a run this morning. You may have been hot and sweaty then but you seem to be okay.

Mr Stevens—that was actually very therapeutic.

CHAIR—A bit like flying!

Mr Stevens—Not that good, Mr Chairman; nothing is as fun as that. One of the things I wanted to say, and we structured the opening statement in order to try to do this, is that, yes, there is a lot of financial volatility at present, and a lot of people are very uncertain and are behaving in a way which in the past few days could be seen as bordering on irrational. That happens from time to time in financial markets. What is key for us is to come back to the fundamentals of this economy, and I think those fundamentals are strong. What we wanted to do today was to talk about the volatility—that is, what is happening, why it is happening and how we should think about it—but to remind people that underlying all this we have an economy that is in good shape. Corporate balance sheets, on the whole, are very good. Household balance sheets for most people are good. Confidence is high, and the economy is flexible. On the whole it is working pretty well, and I think those fundamental forces will eventually reassert themselves through to financial markets.

Dr EMERSON—Going from the very short term to the long run, we know that productivity growth should pick up when the extra mining production comes on in response to the mining investment that has been happening and also to the extent that the drought breaks, so there will
be a kick-up in productivity growth. But do you have any sense of the long-term prognosis for productivity growth in Australia? I think last time you said that there has been quite a slowdown, even abstracting from the effects of mine construction in dragging down overall productivity growth. Is there a case for an ongoing, or perhaps a new, reform agenda to lift productivity growth in an ageing population?

**Mr Stevens**—The big puzzle of a year or two back was when it did not seem to be growing at all. As you know, we did not think there was a very good explanation for that, which had us feeling that it probably was growing but we were not seeing it in the data. I think we now do see some growth, but it is somewhat slower than was typically the case through much of the preceding decade. I am not sure that we are alone in seeing that. My understanding is that, of late, productivity growth in the United States has also been reduced compared to that earlier period. So there is a question as to whether the second half of the nineties and the early part of this decade was an unusually good period and you cannot expect to keep that growth rate going. If that is the case, then the question is what was happening to make that occur, and that would be a big question that I am not sure I could answer. But, in the long run, generally speaking, an economy with open and flexible product and labour markets is obviously a start. These are very general things; we all know them, but they are no less important because we all know them. This is outside my area of competence, but if some of these ongoing reform agendas in water, electricity, transport and so on that we know are on the table can be advanced, they probably holds some promise of assisting productivity.

**Mr CIOBO**—Education.

**Mr Stevens**—Potentially. Skill formation is obviously critical in the modern economy. I cannot be very specific because I do not know enough about them but I think further efforts in all these areas will probably pay dividends.

**Mr CIOBO**—Just picking up on the comments you were making about lag times with productivity growth: with respect to major reforms such as IR reform or any of these kinds of reforms that come through, what is the Reserve Bank’s estimate now of the lag time in seeing productivity growth? You made the comment that you suspected it was taking place but you were not seeing it in the data. Is that consistent with general trends? I am after your general comments on that.

**Mr Stevens**—My comment about not seeing it in the data but believing it was there was really related to a specific episode a year or so back where apparently, on the published figures, productivity had stopped growing completely, which I found hard to believe. I am not sure we really have an estimate on how long it takes for some specific piece of reform to show up in a particular quantum of productivity. I am not sure you can do that calculation, actually; I certainly cannot. Who is actually doing the productivity? It is the thousands of enterprises across the economy who every day in some way seek to improve the way they are doing things by some incremental amount. Central banks cannot do much about productivity at all. The things governments can do are important, but they do not directly do the productivity; they set an environment in which other people are prompted to make those millions of small changes. Therefore, I do not think it is feasible to quantify what will happen in the future if I do something with a policy today. All you can say is that the general tendency is that a well-functioning, open and flexible market economy is likely to be the environment in which the
thousands of enterprises across the place are prompted—pressed, even—to look for those improvements over time. I do not think I can give you a more specific response than that.

Mr CIOBO—From your earlier testimony it is fairly clear that there is a high level of consumer spending and government spending taking place. Exploring that topic further, at a Commonwealth level we now have some $78 billion going into the Future Fund, the creation of the Higher Education Endowment Fund and savings vehicles that are put in place. Am I correct to assume that, if we were to take money that is available from those savings vehicles and actually use those funds on recurrent expenditure, that would further fuel the consumer and government spending you are talking about, which would put upward pressure on inflation rates?

Mr Stevens—What you are talking about sounds to me like a regular common-or-garden-variety fiscal expansion. You are talking about lowering the budget surplus by spending more money. That, presumably, is expansionary, and that would be part of the demand picture for the economy were that to occur.

Mr CIOBO—You may or may not care to speculate on this. There is general interest internationally in what is happening in the United States. I am interested in some of the assumptions, trends, that the Reserve Bank is taking into account with regard to the fact that the United States has been running such a large deficit for some time and we have seen ongoing weakness in the US dollar. I am interested in your comments about the RBA’s estimates and observations going forward over the medium term. What do you envisage is likely to happen?

Mr Stevens—Which deficit do you mean?

Mr CIOBO—I mean in terms of overall government spending—

Mr Stevens—The budget deficit in the United States?

Mr CIOBO—Correct—and if there is a slowdown in consumer spending in the United States as well which further contributes to that.

Mr Stevens—The budget deficit in the United States, as far as I know, has been gradually coming down over time, as tends to happen when growth is good. In most countries, if the economy slows abruptly, you will find that revenues start to fall away, and unemployment benefits and so on would probably go up if you had a rise in unemployment, so the budget would not continue to head in the direction of a surplus but turn around. I do not think we forecast the US budget deficit per se. What we typically do in forming a judgement about the international outlook is look at the current US data, look at what has been forecast for the United States by respected international forecasters, and apply our own judgement to that on occasion. We build that into our general global economic outlook. As I said, you probably cannot do better on that score than to use the IMF forecast or the consensus group, which are typically very similar numbers, and then think about the risks around that set of forecasted outcomes. To my knowledge, in recent years, people have tended to think that the US current account balance is a potential source of risk. I have reservations about that idea per se, but as far as I know there are not all that many people thinking that the budget deficit per se is a major risk to the US outlook; it has, as I said, been getting smaller. But we do not make a forecast of that thing per se.
Ms GRIERSON—Households are carrying much more debt today. Does that mean that the interest rate rises that have occurred, even though they have perhaps been in smaller increments than in the past, are having a more pronounced effect on the household sector than they did in the late eighties?

Mr Stevens—Two things have happened, haven’t they? Debt being carried is much higher, which, for the most part, is a choice by households and is not unrelated to the fact that they feel more prosperous and more confident and have more access to debt. They now have the access they probably always wanted but did not have until the last 15 years. Gross debt levels are higher, that is true, and of course the increments by which interest rates change are much smaller. I remember when interest rates were being moved up in 1988, some six months or so after the share market crash. I think the first move was 200 basis points. Increments of that size, or 100 points, were quite common. They were still quite common as recently as 1994, when we moved 275 basis points in five months. They were very good moves, I might say, which were appropriate for the time. But now we are moving in 25 basis point increments. The gross debt levels have increased, that is true, but the size of adjustments has correspondingly become smaller. That is partly because we are aware that debt levels are high but also because, with inflation much better anchored, you do not need to move in big amounts, particularly if you are prompt, and that is actually a good situation.

Ms GRIERSON—So it is fair to say that we are unlikely to see those types of interest rate rises and that end point again?

Mr Stevens—I would not promise that every increment will be 25 points, but it strikes me as not that likely that we will have 100 point increments any time soon. Something very dramatic has occurred if that needs to be done.

Ms GRIERSON—In your statement earlier, you said that credit terms had been too generous for too long—but we were talking in terms of the wider economy. What role does the Reserve Bank play in avoiding those sorts of credit terms? Does it have a role? Can it have a role? Should it take a greater role? You said it is something you would continue to watch very carefully.

Mr Stevens—We of course do not have any direct power to tell lenders what terms they should extend credit on. I think we do have a role in trying to draw attention on occasion to general trends, and we have drawn attention at some length over the years to these risk-pricing issues and the possibility that there could be an abrupt reversal of some of that at some point. We are not the only central bank to have done that; most central banks around the world have made similar points. As I have said to many people in the past year, if you took a selection of central bank governors, supervisors, securities regulators and people responsible for stability around the world, put them in a room and asked them, ‘What is it that you keep awake at night about?’ it would have been that people are underappreciating risk and taking more risk than they realise and at some point in time that will do some damage.

So I think we have a role to try to speak up, rather as we did as well on what was happening in housing prices some years ago. We cannot directly control that. We should not actually target it per se with monetary policy. But my predecessor, I think to his great credit, did say that there were some silly things happening. I am not sure how much effect that had, but at the margin it
probably had some beneficial impact. That is our role, but that is about all we can do, I think. We
do not, of course, have any power to ring up a bank and say, ‘That spread is too low.’ We are not
the prudential regulator of banks. APRA has that job, with an interest in the soundness of that
particular institution itself. Between us, we have to try to think about risk pricing in markets
generally, make a few general remarks and try to sound the odd warning and so on. But I am not
sure that there is any more we are really in a position to be able to do than that.

Ms GRIERSON—Fundamental to the success of my region’s economy is commodity prices.
Can you share some views on what you think the forward projections are for commodity prices.
Are they peaking? Do you see an ongoing increase?

Mr Stevens—I think some of the metals have probably come down in recent days, but at this
point, as I understand it, those people who are analysing prospects for the bulk commodities—
coal and iron ore—see further rises. Malcolm, could you perhaps elaborate.

Dr Edey—For some time the conventional view has been that commodity prices are close to a
peak and that what we would see is gradual declines from here on. If you trace back forecasts
that have been made over the last three years, we always think we are close to a peak and that we
are going to get that profile, and what has happened is they go up further and then we push out
the expected falls. I think probably for base metals now we are seeing a bit more weakness, but
that follows a period, particularly with nickel, where prices shot up very dramatically earlier this
year. So we are seeing some unwinding of that. As Glenn said, the thing that will make probably
the most impact on the terms of trade is the renegotiation of the bulk commodity prices early
next year. The perceptions over recent months have been that the prospects for those have
actually been firming, so most private analysts have been revising up their forecasts for that.

Mr SOMLYAY—At these hearings we always ask you about the neutrality of interest rates,
and last February you said they were mildly on the restrictive side of neutral. How would you
describe the current settings, given that we are outside of that five to six per cent neutral band?

Mr Stevens—Slightly more on the restrictive side.

Mr SOMLYAY—I had that written down!

Mr Stevens—Those kinds of calibrations are done by just looking at the average of history. I
think that is a reasonable thing to do. It is probably also worth asking this question: how
restraining are the borrowers actually finding it? The way we would probably try to answer that
is to look at what the demand for credit is doing. That has actually increased somewhat over the
past six months. The very short-term data have been affected by what appears to have been a
large amount of borrowing to put money into superannuation in June, and we have to wait until
next month’s number to see how far that falls back. But prior to that there looked to be some
slight firming in demand for credit by households and quite a big pick-up in business borrowing,
with business credit actually growing over the past six months at the highest pace for 20 years.
So I think we are exerting some mild restraint that is probably affecting the households, and now
slightly more after last week. That would be my judgement.

Mr SOMLYAY—Can I go back to your comments on the US subprime market and the effect
on the market in Australia. As you know, the Reserve Bank gave evidence last Friday at the
public hearing we had into lending practices of such institutions. Do you think there is a need for regulation in Australia of the non-deposit taking lenders, mortgage brokers and the like?

Mr Stevens—That is an interesting question. I know your committee discussed that last week. If you do not mind, I will get Phil Lowe to talk about these general sets of issues.

Dr Lowe—I think the main issue here is the regulation of the mortgage broking industry. There seems to be a reasonably broad consensus, both within the industry and at the regulatory level, that something needs to be done there. Over the last few years, the Ministerial Council on Consumer Affairs has been looking at it. The idea has been to try to get a common approach across the states. The process, though, has taken a long, long time and I think a number of people have become dissatisfied with that. I really think that process needs to be accelerated. There is general acceptance within the industry that it should be: that we should have a regime in which there are dispute resolution arrangements that every lender or broker is subjected to, that there are minimum competency requirements, that advice should be in writing and that there should be disclosure of fees. So I do not think there is that much agreement about the core elements of what the regulatory regime should look like.

CHAIR—You mentioned the states. There is some debate as to whether it should be left to the states or whether the federal government should get involved.

Dr Lowe—Under the Corporations Act, ASIC is responsible for the regulation of advice on financial products but not of advice on credit products. That is an issue that today is being left with the states; therefore this ministerial council, at the state level, has been looking at the regulation of mortgage brokers. But I think we have got to the point where the question should be discussed as to whether that should be addressed at the federal level and whether regulation of credit products or advice on credit products should be done by ASIC in a similar way that ASIC does regulation licensing of financial advice. That is an issue between the states and the federal government, obviously.

Mr SOMLYAY—But the events of this week might bring about a sense of urgency, do you think?

Dr Lowe—I think within the industry there is a sense that something needs to be done, and I think in many quarters there is a sense of frustration that the process has taken so long. Obviously what is happening now will put the spotlight back onto it and refocus on the issue of whether it should be done at the state or the federal level.

Mr TANNER—I have one question, which relates to one dimension of the economy that I do not think could be described as strong, and that is exports. I note that we are, I think, the only major commodity exporting country that still has a current account deficit—though the significance of that, of course, is debatable. I also draw to your attention calculations done by John Edwards that were published in the Financial Review a couple of weeks ago that pointed out that the growth in export volumes over the past seven years is about 18 per cent and in the previous seven years it was about 57 per cent. He also pointed out that, the growth in value in the past seven years, notwithstanding things like mineral prices growth, was inferior over the past seven years compared with the previous seven years. I am just wondering if you could respond to this question: what do you think Australia needs to do to improve our export...
performance, noting in particular your observation in your introductory comments today that it would be imprudent to assume that this trend—which is of course in reference to the minerals boom—will continue indefinitely? I am interested in your observations about the sorts of things we need to do as a nation to improve our export performance in the longer term.

Mr Stevens—One of the things that needs to be done and is being done is that the capacity to extract and ship higher volumes of resources needs to go in place. Although that is happening, there are very big capacity increases on the slate for iron ore and coal, as I understand it, over the next few years.

So far as resource exports are concerned, the fact is that people did not see the expansion in demand from China and other parts of Asia coming and so they did not have enough capacity. That is not unique to Australia. That is international. If that were not the case, prices would not be as high. The reason they are so high is that there just is not enough capacity globally. So that is going on. I think it is quite likely that we will see quite a pick-up in volumes of those kinds of exports over the coming few years. I know we have been saying that for a while, but I think it will be true. What price they attract of course we do not know and in the short term it looks as though they may well attract higher prices than we see just at the moment.

Of course, agricultural exports have been badly affected by the drought. No-one knows how to make it rain, but conditions do seem to have improved at least in some parts of the country so I suspect they will do a bit better in the coming year or two.

Manufactured exports are certainly growing more slowly than they did. They grew very rapidly for 15 years or so. I think they are still; I do not have the figures right in front of me, but I think they probably are still rising. It is a pretty tough six per cent volume over the past year. It used to be 16 for many years, so clearly it is lower than that. But six is nothing to sneeze at. It is a pretty tough world in which to compete with the low-cost centres of Asia on at least low value added type manufactures. So I think the future there presumably lies in the same trend they have been going in for some time, which is to find niches where they have particular skills and value they can add and do the best they can.

It is true that exports have tended to lag in volume terms, but I think on the bulk commodities that is going to change. As for us being the only commodity exporter to still have a current account deficit, you could turn that around and say that we are the only one of those countries that is so attractive to international capital that the rest of the world wants to put that money here. I am not sure I am apologetic about that. By and large, that is a strength. So there are a couple of ways you can look at that.

Mr McArthur—I raise two issues. Some commentators suggest that interest rates around the world are rising, particularly in some of those countries that have a very low base at the moment—for instance, Japan and some of the European countries. Would you care to give us a comment as to your attitude to that view?

Mr Stevens—It has been the case that in many countries monetary policy rates have been on the way up over the past year. The US is an exception, of course, because they had reached normal some time back and have not done anything since. But rates in Europe have tended to be unusually low and they have been raising them. In Japan, they have been extremely low, of
course. I do not really know what my counterparts in those two places are actually intending in the near term. I would have to say that, in my view, the sooner Japanese interest rates are able to be normal again the better from the point of view of the global financial system. It is an unusual situation. It is fundamentally a distortion to have a G3 country with the short-term interest rate at the lowest for a century—in fact, long-term interest rates we at one point calculated as the lowest for 500 years anywhere in the world. That is a very strange thing to occur. You can see why it happened, with the experience that Japan went through with the bubble economy, the deflation of asset prices, the serious credit problems they had. I would have cut them to the same point, if I had been in charge there. So it is not a criticism of them, but the sooner Japan looks normal again and has normal interest rates, the better really I think for global financial markets. I am not sure how soon that is going to be, though. I do not really know, but it seems to be a long slow process of normalisation there.

Mr McARTHUR—Given the huge growth of the Chinese economy, if there were an aberration or a setback or a collapse of that economy, what attitude would the bank take to that in view of the exports of commodities to China?

Mr Stevens—China is becoming quite a powerful economy. It is growing very rapidly—12 per cent or so, if the figures are to be believed. As we know, it has had quite an impact on global relative prices, particularly prices of our commodities; it has been important for Australia. So, were they to stumble, I think we will notice the effects for sure and that will be quite an important thing. If they fall over at some point, I suspect they will fairly quickly jump up, dust themselves off and get going again, because I think their policy intention over a quite long period is to grow rapidly. But I do not think there is any doubt that factoring in China’s experience and prospects to the outlook is a much bigger thing, a much more important thing to do now than it used to be—without doubt.

Mr KEENAN—Governor, I want to return to the issue of government debt, particularly the $70 billion of state debt. We seem to have been operating under the assumption that this money was being spent on infrastructure, but do we actually have any evidence that that is the case?

Mr Stevens—Isn’t it the case that it has not actually been spent yet?

Mr KEENAN—It is projected to be spent over the next four years.

Mr Stevens—The $70 billion, as I understood it, comes from an accumulation of what the announced infrastructure plans are, doesn’t it? Are you asking me do I know that they will actually spend it on what they say? I do not.

Mr KEENAN—No. I suppose what I was asking you is: is there any evidence that the states are spending more on infrastructure than they traditionally have? States have always been responsible for this sort of infrastructure.

Mr Stevens—I think there is some evidence that that spending is currently being ramped up and has some further to go. I think we published some material on that in our statement—not this one perhaps but in the previous one. I do not think there is much doubt that that is occurring.
Mr KEENAN—There is some evidence to suggest that the states are actually increasing their workforces and paying their workforces more. If that funding were being spent on that, would that change your view about its inflationary effect?

Mr Stevens—I am not sure. If government X in state Y employs more people and pays them, that is government final expenditure on public servants. If they spend money on infrastructure, that is government final expenditure on investment. It may be that the implications of those things for the economy in the medium term are different because the spending on infrastructure adds to supply in the long run. We could, I suppose, debate how much addition to supply potential is created by spending money on more public servants; it depends on what they are doing, I guess. Both of those things, in the near term at least, are government final expenditure, aren’t they, on goods and services?

Mr KEENAN—I suppose that one of them would be a one-off if you were building a port or rail line or something like that, whereas if you are just employing more public servants and paying them more that will increase your cost base over the longer term.

Mr Stevens—Could be. It is certainly important to avoid embedding excessive cost structures in these things. I agree with that. I am sure that the heads of the state treasury departments would be equally concerned to avoid that, if I know them.

Mr KEENAN—If we did accept that this debt was being spent on infrastructure, we would not actually see a productivity pay-off for some time. In the intervening period, that would be inflationary.

Mr Stevens—What you have in the intervening time is demand. In the same way that when a business spends money on a piece of plant or equipment or a rail line there is an increase in demand, and in the long run there is going to be quite a big increase in supply of the output of that firm. I am not sure how different it is for a government owned water utility or electricity authority or something like that to also do investment. It adds to demand and, in the medium term, it adds to supply. What is the difference between those two things, other than that one is public and one is private? What matters is that we do not want the total demand in the near term to be too high because we do not want to inflate the cost structure of the economy.

CHAIR—In the remaining 12 minutes, I have a couple of quick questions. If my colleagues wish to participate they should let me know. In your February appearance before this committee you indicated that you saw household balance sheets as being in reasonably good shape. Do you continue to have that view?

Mr Stevens—Yes, by and large. Household assets are still rising. Debts are rising too but I think that is manageable for most people. By all indications, confidence is high, incomes are growing well and, contrary to what we sometimes read in the papers about servicing debt and so on, the evidence from the lenders—and they are the people with an interest to know—is that the proportion of loans where there is a real struggle going on has gone up a bit but remains very low. I think that, on the whole, households are in good shape. That is not to deny that there are pockets where there is genuine distress. There are; but, at present at least, as distressing as those pockets are, I do not think that they are macroeconomically significant.
CHAIR—Would you identify that as the non-conforming loans sector where the stress is occurring?

Mr Stevens—Arrears rates on non-conforming loans are much higher than they are on normal loans, but that was always expected or even intended. These loans are more risky. The borrowers know that. They charge a spread which is much higher to cover and, as far as I know, at this point they have been well and truly paid for the risk they have taken in terms of their arrears experience. Losses to date have been minuscule and far outweighed by the spread that they are earning. That is the subprime component of our story.

Where the pockets of pressure are in, say, the western suburbs of Sydney, what you have seen there is, in broad terms, that the boom went later, went a bit further and was probably more detached from fundamentals because the fundamentals for those properties are not as good as they are in Double Bay or somewhere. These were more likely to be ordinary people who were drawn in by all the hype on investment seminars and so on. With the relative slowness in the New South Wales economy over the past few years, the unemployment rate in some of those areas went up a bit and house prices went down. If they have stopped falling at all, it was probably only very recently. That is where the pressure is most concentrated, in the Sydney region anyway. It is in those areas where you are most likely to have situations of arrears, defaults, repossessions and so on. I think there is a concentration in that area. It may partly be to do with subprime, but it is probably mainly to do with just the fact that the boom proceeded there in the way and with the timing that it did.

CHAIR—If we see a reduction in interest rates by the Federal Reserve, are we likely to see a follow-on in terms of the Reserve Bank of Australia?

Mr Stevens—I doubt that we would be contemplating a rate cut any time soon. We would have to have quite a different view on the outlook for inflation than we presently do. I am not saying that could not happen, but a fair few more developments would need to occur before we do. The markets are pricing cuts by the Fed, which does not mean the Fed will do it. They are pricing that, but I think they are still pricing an increase by us within the next year. That does not mean we have to do that either, but current expectations are quite different between the two countries—and not without reason, I would say.

Dr Emerson—I have a general question on economic modelling. If you are seeking to model the impact of various microeconomic policies, like financial market liberalisation, product market liberalisation and labour market changes, how feasible is it to isolate one of those in terms of effects on employment income productivity? Is that a technically feasible exercise or are they all mixed in together?

Mr Stevens—I think to address questions like that you need a sort of a structural model of the microeconomy, which is not something we do. I am going to have to defer to the greater expertise on my left on any detail here, but my guess is that those are the kinds of models that the Productivity Commission would typically be inclined to use rather than the sort of macro streamlined things that we do. Is that right, Malcolm?

Dr Edey—Usually at a macro level the way people try and do this is to come up with very broad summary indicators of things like the degree of product market regulation, the degree of...
flexibility in the labour market and so on. The OECD has done a lot of work in that area, trying to quantify those things. We have done a little bit of work in that area, but I would not claim that we are great experts on it. Usually what those things pick up are general tendencies. They do not really isolate things that are happening one individual measure at a time.

**Dr EMERSON**—What I am getting at is whether, when these things are happening together, it is feasible to then say, ‘This is the impact of a financial market.’ Say you have liberalisation of financial markets, product markets and labour markets—can you just concentrate on the financial market liberalisation, the labour market liberalisation or the product market liberalisation and then get results out of one of those even though the three are all happening together?

**Dr Edey**—To some extent at that very general level you can get separate estimates. For example, you can look at the general effects of product market deregulation and labour market deregulation. The other thing that studies in this area find is that those things interact, so, if you are comparing across countries, you will see that countries that have both kinds of deregulation do better than the sum of the individual components would lead you to expect.

**Mr Stevens**—You get more observations by having the cross-country story.

**Dr EMERSON**—I am wondering how, if you were doing a time series—

**Mr Stevens**—A time series in one country is going to be harder.

**Dr EMERSON**—Hard to disaggregate?

**Mr Stevens**—Yes. I think that is right and I think that, if I am understanding what Malcolm is saying correctly, if you have cross-country panel sets and you deregulated in this year and you did it that year, maybe that would allow us degrees of freedom to isolate them.

**Dr EMERSON**—If you have a data set that allows you to do some isolation, but if you are doing time series in an individual country it is not so easy.

**Mr Stevens**—I would tend to think that, yes.

**Mr SOMLYAY**—Following on from Bruce’s question, what is the likelihood of the market rate of interest taking the place of the need for the cash rate to be increased?

**Mr Stevens**—Let me rephrase this question—

**Mr SOMLYAY**—Thank you.

**Mr Stevens**—to something easier to answer. I think you are asking if the financial markets are going to do another tightening for us. It remains to be seen, but if they do then obviously we factor in that change to the market. Basically, we are talking here about the spread between the rates that the banks and other lenders charge and the cash rate. If that is moving, as it sometimes does, we obviously have to take that into account. I might say that in the past five years the spread between the actual mortgage rate people pay and the cash rate has come in, which has, in
a very real sense, acted to offset some of the tightening we have done. So, yes, we take account of those things. As to how market rates will actually settle after all this, things are a bit fluid at the moment, so it is hard to tell, but we certainly will be watching that.

Ms GRIERSON—You just said that the markets have already costed in the fact that the Fed are likely to decrease their interest rates and that they are predicting that there is a chance that the RBA will increase interest rates. Some have suggested that there is a correlation. Is it fair to say that, if the Fed decrease their interest rates, there is a higher likelihood of a further interest rate rise this year?

Mr Stevens—If the Fed reduce their rates, does that make it more likely that we will raise ours? I am not sure that it has any particular bearing on that probability. In my experience, it usually pays to ask why the Federal Reserve would be doing that and what that means for the US economy and for us. That would be the thought process I would be going through, and then we would decide ourselves whether that changes any setting that we might need to have.

Mr KEENAN—This might be a question for Dr Lowe. We have had a lot of talk today about low-doc loans, and these things seem to be viewed very negatively. But there is actually a good case for a lot of people who are not traditionally able to tick all the various boxes of a bank still to be able to get finance to buy their home. So is the problem with the loans themselves, or is it that the risk associated with them has not been priced properly?

Mr Stevens—I agree with you that, in focusing on the trouble that some of these loans have got into, we should not forget that there are a lot of people in the United States and in Australia who have better access to finance today as a result of financial innovation. The arrears rate on subprime loans in the United States I think is running at about 15 or 16 per cent at the moment. It may go up, I suppose, but at the moment what that says is that 85 per cent of people are making their payments. Quite a lot of people presumably are therefore in a house that they might not otherwise have had. They may be finding it hard but they probably would prefer being there to the alternative.

So financial innovation, as I said earlier, is a kind of two-edged sword: it carries good things but it also carries things that can go wrong. I think basically here the risks were not as well appreciated as they should have been. I also think there is a problem in the way these loans get marketed. This is particularly acute in the US, because the salesman who sells you your loan is paid for doing that, and the more of those loans he sells, the more money he makes. But it is not his money that he is lending. There is potentially a disconnect here—and in actuality, as it turns out—between the people who are putting up the money, and therefore taking on the risk, and the people who are actually selling the loans. Selling finance is not the same as selling a used car; it is different. Part of what is needed, apart from anything else, is a better discipline process on the sales part of the provision of these loans. I think that is quite important and I expect that our American friends will be putting some attention on that.

CHAIR—The final question from our local member, Mr Ciobo.

Mr CIOBO—Given that this is the second half, I think there should be at least one token question on the payments system—
CHAIR—It would have been ignored otherwise.

Mr CIOBO—and I thought that I should ask it. Could you, Governor, or perhaps Dr Lowe, update the committee on where we are with respect to market shares between the regulated and unregulated exchange rates and give us some general comments about the next 12 months with respect to the review the Reserve Bank is undertaking on interchange rates?

Dr Lowe—So there are two questions there. The first one is on the market shares of American Express and Diners Club and there really has been no change there for the last two or three years in terms of the value of transactions. It is between 16½ per cent and 17 per cent and that is where it has been for the last three years.

In terms of the review, you might have noticed that we released an issues paper in May this year. Submissions are due on that by the end of this month. We have asked three broad questions—what do people think have been the effects of the reform to date; should we be thinking about a different regulatory approach and, if so, what should that be; and, thirdly, if we keep the current regime, what changes should we make? So really we are proposing a very broad ranging review. It is very open and transparent. We are holding a conference with the Melbourne business school in Sydney at the end of November when we have invited about 100 industry participants to come and discuss the issues. After that is over then we would have our internal deliberations after consulting further with industry, and we plan to release at least our preliminary conclusions in about April next year. So it is a long drawn-out process but we feel that that was important because the issues are intrinsically important. They are difficult, there is a lot of industry analysis and consultation that needs to be done, and we wanted to make sure that the review was very wide-ranging.

CHAIR—Thank you for your participation today, Governor and members of the Reserve Bank. We appreciate your involvement and the cooperation we have had with the committee. This is my last session of chairing this committee and so I want to thank all the committee members and the Reserve Bank for their participation and cooperation. I appreciate it.

Resolved (on motion by Dr Emerson):

That the committee authorise publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at the public hearing today.

Mr Stevens—Chairman, since this is your swansong, can I thank you for the gracious way in which you have conducted proceedings today and on previous occasions. We wish you well. I have sure I will run into you at Cronulla at some point. You will be emerging from the surf and I will be shuffling along in my runners like an old man.

CHAIR—I declare this public hearing closed.

Committee adjourned at 1.04 pm