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Members: Mr Craig Thomson (Chair), Mr Pearce (Deputy Chair), Mr Bradbury, Mr Dutton, Ms Jackson, Mr Keenan, Mr Marles, Ms Owens, Mr Turnbull and Mr Turnour

Members in attendance: Mr Bradbury, Mr Dutton, Ms Jackson, Mr Keenan, Mr Marles, Mr Craig Thomson, Mr Turnbull and Mr Turnour

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2007
WITNESSES

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

DEBELLE, Dr Guy, Assistant Governor, Financial Markets, Reserve Bank of Australia

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

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

CHAIR (Mr Craig Thomson)—I declare open this hearing of the House of Representatives Standing Committee on Economics. I welcome representatives of the Reserve Bank, members of the public and the media. I also welcome students and staff from East Hills Girls Technology High School, Sydney Secondary College, Newington College, Fort Street High School, Caringbah High School and MLC. The hearing today provides an opportunity to examine in more detail the increase in inflation, which has prompted the Reserve Bank to increase the official cash rate to 7.25 per cent, up 75 basis points since the former committee met with the bank last August. The bank has now increased the cash rate 12 times since 2001, with a total of 100 basis point increases from 8 August 2007. The committee will be interested as to whether, after four recent rises, inflationary pressures as indicated in the February Statement on monetary policy are being reined in.

The committee will also seek views on other significant issues, including the state of the Australian and international economies, focusing on the impact of the US subprime mortgage crisis. In addition, the committee will seek an update on consumer confidence levels in the light of recent rate rises, the health of household balance sheets, bank profitability and low rates of productivity despite high economic growth.

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. Mr Stevens, would you like to make your opening statement and then we will proceed to questions.

Mr Stevens—Thank you. My colleagues and I are pleased to be here to appear before this newly re-formed and renamed standing committee. I look forward to productive sessions with you over the life of the parliament. I will begin by reviewing the economy’s performance over the past year, and then I will offer some comments about the current conjuncture—some of the issues that we face in the period ahead. All that will, hopefully, provide some context for our discussion about monetary policy.

The Australian economy recorded another very strong year in 2007. Real GDP expanded by about four per cent and growth in domestic final demand was even stronger at over 5½ per cent. The rate of unemployment declined further, the most recent readings reaching its lowest level
since the mid-1970s. Indicators of capacity utilisation reached their highest levels for two decades, and firms continue to report considerable difficulty in expanding operations due to shortages of suitable staff. These outcomes for demand and output growth exceeded those in either of the two preceding years and are stronger than was expected a year ago, particularly in the case of domestic demand.

In explaining those trends, a noteworthy factor is that the global economy continued to offer a very supportive environment for Australia, notwithstanding the evident deterioration in the United States and the serious disturbances in international capital markets in the latter part of the year. The cumulative impact of the very large rise in Australia’s terms of trade over a number of years continued to flow through the economy.

Very high levels of confidence in the business community saw robust growth from already higher levels in capital spending. This was most pronounced in the resources sector, and that is not surprising given the level of demand and the prices being paid for its output, but the strength was not confined to that sector. To this was added the response of governments and associated enterprises to the need for upgrades to public infrastructure and other demands, which saw public final spending rise at about twice its trend pace over the course of 2007.

Finally, consumer demand also rose at a pace well above average, fed by a rate of growth of real household disposable income as high as anything seen in the past 20 years. The only major aggregate on the spending side that was on the soft side was dwelling investment. While there continue to be differences in the degree of overall strength of the economy by region, those differences have if anything narrowed during 2007. Unemployment rates in the big south-eastern states, for example, were at generational lows in the most recent reading.

The pace of demand growth in 2007 well and truly exceeded any plausible estimate of the rate of growth of the economy’s supply potential. Under those demand conditions, inflation increased. Having apparently moderated a little late in 2006 and early 2007, it began to show higher readings around the middle of 2007 and by the end of the year had reached about 3½ per cent in underlying terms. Measured by the CPI, the year-end inflation rate was three per cent, but, as is I think well understood, the next figure is likely to be around four per cent.

Faced with this combination—that is, very strong demand growth in what was already a pretty fully employed economy and inflation moving higher—the Reserve Bank board when discharging its monetary policy duties could draw no other conclusion than that growth and demand needed to slow. The board had tightened monetary policy on three occasions during 2006. It then stayed its hand for a period in the first half of 2007 as inflation results available at that time suggested some moderation. But, as the trends of 2007 and the likely risk that they posed to longer run performance emerged, the board tightened policy further during the second half of the year and in the early months of this year. The cash rate was raised, as you said, Mr Chairman, on a total of four occasions, with the aim of achieving a moderation in demand, which is an obvious necessary condition for reducing inflation over time. In reaching those decisions, the board naturally took careful account of the unfolding events in global financial markets. I will not recount again those details now. I and others have done so at length before and I am sure we will return to those in question time.
As a daily participant in markets, the bank was in a position to observe developments very closely. Our senior officers have been in frequent contact with all the significant financial institutions who operate in Australia, with our colleagues at APRA and other regulatory agencies and with our counterparts abroad. The RBA board spent considerable time at its meetings—and still is spending time—examining market developments and considering their possible implications. The RBA responded to the unusual demand for liquidity on a number of occasions and made early changes to its practices for open market operations to accommodate dealing in a wider range of assets and over longer terms.

These market pressures were, and remain, overwhelmingly a flow-on of international forces. They are not predominantly or mainly a result of local factors. But it is appropriate, in our judgement, to foster confidence to the extent we can during periods of global stress such as we have been experiencing. Despite those actions, a financial system such as ours cannot be entirely insulated from these global events and inevitably the Australian financial system has been affected to some extent. The rise in the wholesale cost of term funding has meant that many non-bank and some bank lenders have had to slow the growth of their businesses. The closure, more or less, of securitisation markets for the time being also has made life more difficult for those lenders which relied heavily on that avenue for funding. Capital market raisings are much more difficult for some corporates as well, and many of these entities are turning to their bankers.

By and large, the major banking institutions have been able to provide support for sound borrowers and have stepped into the gap left by the withdrawal of funding from the capital markets. They have been able to do this because of their own balance sheet strengths—something which is clear from the analysis in the bank’s recently released Financial Stability Review. While some of their customers have been excluded from capital markets of late, banks themselves have been able to access segments of the capital markets in sufficient quantity to keep their balance sheets expanding. This has come at a time when wholesale funding costs have been rising by more than the official cash rate and that has been passed on to end borrowers while conditions on lending for some borrowers have tightened in response to higher perceived risk. But this outcome is preferable to the alternative of lending drying up.

At present, the international environment remains very difficult. The US economy is experiencing very subdued conditions as the weakness that had for some time been confined to the housing sector has spread to other areas in recent months. Losses incurred by major international financial institutions associated with previous risky lending have continued to come to light even during this week. Valuing certain classes of assets remains very difficult and some quite sound assets appear to be being valued at less than their true underlying value. A process of deleveraging is continuing among hedge funds and other complex financial vehicles as the retreat from risk by their lenders forces a winding in of positions. While all this has been occurring, financial market participants have understandably remained very nervous and day to day volatility in financial markets has been much higher than participants have become accustomed to over recent years.

In the meantime though, real savings are still flowing into the accounts of institutional investors—pension funds, super funds, insurance companies and so on. Given the present level of uncertainty, those responsible for investing those funds are remaining very cautious, fearing further write-offs by the large international banks and declines in asset values. Hence, they are sticking to very large positions in short-term liquid investments. There is little appetite just now
to commit funds to more risky or longer term uses. The normal functioning of capital markets can really resume only when those sorts of investors regain the confidence to make those commitments. As a result, the outlook for the United States, where credit concerns are most acute, where capital markets are most important for the flow of credit and where house prices are falling, is for weakness in the near term. Most forecasters have been revising down their numbers for 2008. Considerable stimulus has been applied to that situation by the US authorities with policy interest rates declining sharply and a fiscal stimulus package imminent. The US Federal Reserve has also taken some forceful actions in recent days to stabilise the financial system.

Growth in the Euro area appears to be moderating as well, although at this point not by as much as in the US, and the Euro area authorities continue to express concerns about inflation. Japan’s economy is also weakening, partly as a result of international forces but also partly due to purely domestic events. Economic conditions in the rest of Asia, on the other hand, have continued to be quite solid. Growth in industrial production and exports has been strong in the first couple of months of this year. Weaker US conditions are affecting Asian exports to that country, but to date exports to other countries have compensated for that. The Chinese economy, with its demand for natural resources, has continued to expand strongly. The impact of the global turmoil, via financial linkages to Asia, has affected share markets in the region, but there does not appear so far to have been any noticeable effects on the capacity or willingness of Asian banks to extend credit. In fact, domestic financial conditions in Asia remain quite expansionary, which is contributing to considerable strength in domestic demand. Inflation remains a concern in many of these countries and, if anything, that concern could be said to be growing.

The net effect of all these forces is such that Australia’s trading partners as a group are likely to record below average growth in 2008, reflecting weak outcomes in the developed world and slower but still pretty solid, good growth in Asia. But, at the same time, higher contract prices for coal and iron ore which are about to take effect will, all other things equal, lift Australia’s terms of trade by perhaps a further 15 per cent, adding two to three per cent to national income over the next year or so. This expansionary impetus comes after a 40 per cent rise in the terms of trade over the previous five years. So the world economy presents some considerable cross-currents for Australia. We have the biggest terms of trade boom for 50 years at the same time as we have one of the most serious malfunctions in developed country capital markets in a long time.

Looking to domestic conditions: most indicators of actual economic performance for the early part of 2008 have remained quite strong; employment has been very robust; and survey based measures of actual business conditions have remained strong, even if off their late 2007 highs. We do think, however, that demand growth in Australia is now in the process of moderating. The demand for credit by households has also been weakening over recent months. Measures of confidence have declined. While those measures can provide false signals, our assessment is that a change in trend is occurring, and we are hearing that from businesses that we talk to. A tightening in financial conditions, lower share prices and heightened concerns over the global financial problems will all have played a part in that change. The likely extent and persistence of this slowing in demand is quite uncertain, as these things usually are. There remain powerful conflicting forces at work, as I said, so we can expect, I think, that difficult issues for judgement will remain with us for some time. These are the issues with which the RBA board has to grapple.
At its meeting this week, the board reached the view that for the time being policy settings should remain unchanged. The current rate of inflation is clearly uncomfortably high and, were expectations of high ongoing inflation to take root, it would be even more difficult to reduce inflation again. Hence, policymakers are obliged to have in place a policy setting that represents a credible response to evident inflation pressures. But the significant tightening in financial conditions that has occurred since mid-2007 is a strong response. Short-term interest rates are towards the top end of the range experienced during the low inflation period. The board is also conscious that some non-price tightening of credit conditions is probably occurring at the margin. These factors should be working to slow demand. There is at least some evidence that a moderation in demand is occurring, and that, if it continues, should in due course act to slow prices.

We will be receiving a round of prices data in a few weeks time. That will afford another chance to review both recent performance and the outlook. As I noted earlier, the headline CPI rate is likely to be high. We will naturally examine the outcome for new insights about the extent of inflation currently occurring but, as well as that, it will be important to make continuing assessments of the extent of both the likely moderation in demand and its effect on inflation over time. This will by no means be an easy balance to strike but, if by restraining demand for awhile we can secure a gradual reduction in inflation over the period ahead, then an important foundation of Australia’s good macroeconomic performance over the past decade and a half will remain in place. That in turn will offer the prospect of good sustainable growth into the next decade. That is the goal of monetary policy. Mr Chairman, my colleagues and I are here to respond to your questions.

CHAIR—Thank you, Mr Stevens. Before we move on, could a committee member please move that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication.

Mr BRADBURY—I move that way.

Mr PEARCE—Seconded.

CHAIR—That is carried. Mr Stevens, you have forecast for the end of 2008 an underlying rate of inflation of 3.5 per cent with the figures trending down from that point. What are the key assumptions behind those forecasts and what is the RBA’s current view of inflation during the current economic cycle?

Mr Stevens—The forecasts were in the February SMP, which I think are the ones that you quoted there. The assumptions that underlie those forecasts are set out in the document. There is an exchange rate assumption, an oil price assumption and an assumption of the cash rate being in fact what it was at the moment those forecasts were made, which was actually 25 points lower than it is today. So when we come to update these forecasts in our next SMP, which will be in early May, I would expect to see these forecasts for growth and inflation looking a bit lower. That of course is the intention of the rate rise that we made in March, so the assumptions are there. Another critical assumption is the world outlook, and I think we had moved fairly early to the position that growth in our trading partner group was going to be below average. I think other forecasters are coming down to that position now. We had already moved to that place a couple of months back. So that is an important one.
The second part of your question, if I interpret you correctly, was: what do we think the average inflation rate will be over the cycle? The difficulty in answering that of course is how long the cycle is, and, until it is over, we do not know the answer. But I suppose if we look back over 10, 12 or 13 years or since about 1993 the average inflation rate has been 2 1/2 roughly. And what we are trying to do is make sure that in five or 10 years from now when we look back again, we get that same sort of answer. Obviously, at this point in time we need tight policy to put some downward pressure on inflation to make sure that we trend back towards those lower numbers, and that is how you get an average in the twos.

CHAIR—Following up on that, what would be the impact on the economy for us if we just ignored the inflation? Would this lead to higher or lower interest rates in your view?

Mr Stevens—That is a good question. I think it is quite clear from any study of history, either ours or any other country, that if you do not control inflation then ultimately you end up with higher interest rates. Over the past 15 years, if you just take our cash rate as an example, the cycle in that has been between the low fours and about where we are now—where we are now is pretty close to the peak we got to in 1994. The average is 5 1/2, six or something like that. So as long as you have got a stable trend inflation rate, the nominal interest rates cycle around a stable mean as well. If you have got higher trend inflation then ultimately the average level of nominal interest rates is going to be higher. Quite possibly the average level of real interest rates might end up being a bit higher too, and they certainly will if you decide, as you will have to eventually I think, that inflation has to be brought down. So to ignore inflation pressures and not respond, although easier to do in the short run, leaves you with a serious problem in the long run and you end up with higher interest rates than you otherwise would have. That is why it is important to act as promptly as you can and contain this so that we can continue to have the same sort of structure of nominal interest rates that we have had since the early 1990s.

CHAIR—I have got one more question before I hand it on and that is in relation to banks. Since 2004-05, the four major banks have increased their net profits by about 25 per cent on average. Given that for the last 10 years bank profits have been at extraordinarily high levels and the March 2008 Financial Stability Review states that the Australian banks remain robust, surely increases above the RBA increases can only be seen as an attempt to maintain bank profits at the extraordinarily high levels that they have been in the past decade. Has the bank been concerned about lending practices by some providers in Australia, given this history? It is not just that the banks’ profits have remained high; even taking account of the recent share market volatility, the increase in share market value of the shares of the major banks is also extraordinarily high when we look at it over the past 10 years.

Mr Stevens—There are a few questions in there. Actually, bank share prices have come down quite smartly in recent months. You are certainly correct to say that a shareholder in a bank has done very well over a decade. They are very profitable institutions; that is certainly true. But at present what is happening is that their costs of funds are increasing by more than the cash rate rise. That is a fact. Like any business, they are seeking to cover those costs of funds in the price of their product. But the thing to remember is that we are taking account of that in setting the rate that we set. We could not know precisely how much more than the cash rate rise their rates would go up by, but it was obvious that there would be some effects, and we have been calibrating for that all the way through in what we do.
While I know that in some ways people feel, perhaps, aggrieved that banks are highly profitable, there are a lot of other banks around the world right now that are bearing very large losses and are struggling to replenish their capital, and because of that they are not in a position to do much lending. So, if you were to ask me which of those scenarios I think is preferable, the one we have—for all the presentational issues that it gives us—is the preferable scenario of the ones that are on offer around the world. Our banks—as you say, our FSR commented on this the other day—are strong, profitable and well capitalised, and that means they are in a good position to do the job we need them to do. That is a very important point for people to understand, I think. The economy would be much worse off were it otherwise.

Mr PEARCE—Governor, good morning. I would like to ask you a few questions in and around the area of inflationary expectations. I want to start by referring to the speech that you gave on 11 December last year to the Sydney Institute. You said:

Even more important are expectations of future inflation. When people expect prices to rise rapidly, they bring forward purchases, put up their own prices, demand higher wages and so on. That helps to create the very inflation they expect.

What types of factors do you believe drive inflationary expectations?

Mr Stevens—Actual outcomes certainly play a role. One of the things that we have to work on at the moment—and I am very conscious of this—is that we need to have a credible story for people as to why inflation, which is clearly currently high, is going to come down over time. That is why, as I said in the opening remarks, the policy setting has got to be able to be in such a position that we can credibly say, ‘Yes, that will do the job; inflation will come down.’ So that is part of the management task that we face.

Over the long run, my observation from looking at this stuff for a long time and examining our own experience and that of other countries is that, in the countries which have a monetary policy framework which (a) has a demonstrated track record and (b) has a measure of public confidence, where the central bank is serious about containing inflation and you have the institutional set-up that allows you to do that, all those things, over time, are the things which are conducive to keeping expectations anchored, and if we can do that it makes the job so much easier.

Mr PEARCE—I also noted in the recent minutes of the board that it expressed concerns in and around this area of inflationary expectations. So, if inflationary expectations do rise, is it a fair thing to say that this by necessity requires the board to have a much more restrictive approach to monetary policy than you would otherwise?

Mr Stevens—If expectations rise and stay high that does make it harder to get inflation down. Whether the level of interest rates is actually higher or whether it has to be held for longer, there is probably some discussion to be had there, but I do not think there is any question that a serious rise in expectations—even if they then stick up there—does make the job harder, which is why you have to try to act to manage them. That is what we are trying to do.

Mr PEARCE—Some people have said that ‘the inflation genie is out of the bottle’. The plain meaning of an expression or a phrase such as that is that something, if you like, is out of control,
off and running, cannot be controlled, cannot be fixed—it is all over the place. My question to you is: would you agree that inflation is out of control?

Mr Stevens—I do not want to comment on colourful things that are said in public debate, but what we have said is inflation has risen and that is a problem. It has to be dealt with and we are dealing with it. We will contain it and it will come down. Is it out of control? No, I have never said that. I have tried, if you like, to make balanced comments that one cannot say that there is not a problem. There is a problem, but I do not think it is out of control. I think it will be controlled, and that is why we are doing what we are doing. So, there is a problem, a response is needed, it is being made and it will work.

Mr TURNOUR—I want to go to a few issues of banking. I take on board some of the comments about rates increasing. We have seen rates increase over a period of time and, clearly, that has been in response to inflation issues that you have already touched on in your statement. I am from Cairns. There is a lot of discussion about mortgage interest rates in some of the capital cities, but I can assure you that in regional centres and other parts of Australia mortgage interest rates are also causing significant concern to families. One of the issues that you have touched on is the fact that bank lenders have already increased their rates beyond the cash rate. One of the things that I, members of my community and the broader community would be interested in is whether you believe that the decision by most mortgage lenders to raise rates independently of the cash rate was unavoidable. In the absence of these rate rises, is it likely that the Reserve Bank would have had to raise official cash rates more than it has? In other words, have rate rises by the banks averted further official rate rises by the Reserve Bank?

Mr Stevens—Those are the questions that people want to ask. I think, as I said before, the cost of funds to the banks has risen by more than the cash rate has risen. A little bit of perspective here may be of some help. I am old enough to remember a much earlier time when bank interest rates were regulated quite heavily. They could not raise loan rates, which meant they could not raise the funds to profitably lend, which meant they did not lend. If you go back to the 1970s and the early eighties, before the interest rates were allowed to move, when conditions tightened up, you did not get a graduated response of lending slowing down; the tap just got turned off.

I know that it is a concern about the extent to which banks raise interest rates. As I said earlier, we are taking account of this widening gap between the cash rate and the actual lending rates in what we do with the cash rate. But we do not want to have a world where banks cannot make an adequate return on the lending and stop doing it. That, I can assure you, is a far worse world than the one we currently inhabit, for all the problems that we may have. So, yes, I think it is likely that we would have been going up more on the cash rate up to this point had those margins not been widening, but we could see they were widening and so we took account of that. It is probably also worth remembering that, for many years, the margins on mortgage rates relative to funding costs for banks contracted. They contracted quite a lot, independently of anything the cash rate did. So, over some years, you actually had a net decline in mortgage rates relative to the cash rate, and that has not been fully reversed up to this point. They are widening now, but do not forget that for quite a long time it was going the other way. It went quite a long way over a number of years.
Mr TURNOUR—With the narrowing that I think you were talking about was the increased competition that came into the market, with some other lenders becoming involved, and clearly we have seen that unwinding with the US subprime and flowing through to Australia. Are we seeing structural changes now in terms of the market share of the different lenders—in effect, the banks growing their share of the market?

Mr Stevens—Yes.

Mr TURNOUR—What impact does that have in terms of policy going forward?

Mr Stevens—We are seeing those changes in share. In one of our publications—it could be in the FSR—there is a chart that shows those swings. Those lenders who had a very heavy reliance on wholesale funding and/or securitisation have had to slow right down because the fundamental profitability of that business model has changed completely with the events that we have had in global markets. What has happened is that the larger banks have basically made up for that, so the market shares have swung around, as you say. That, I think, is just an inevitable outcome of the way the global markets have moved. That change in market share has certainly occurred. What are the implications of that for our policies? I do not think there are any huge implications in the near term. There is an issue of course of how competitive the mortgage market can be over the longer term, and we all want competitive markets.

I would add one slight caveat, which is that Australia has been very fortunate that the kind of subprime lending that we have seen cause such a problem in the United States is very rare here. There was a little bit. I do not think there is very much now. I think all of that has probably stopped. To be honest, that is a good thing because otherwise, if that kind of thing goes on and grows over a number of years, you start to go at least towards, if not to, the point where the Americans have now found themselves, and that would be a damaging thing. There is an issue of competition in the mortgage market. I think over time we will probably find that after all this calms down securitisation will become feasible once again. These are very high quality mortgages in this country. They will be very attractive assets at some point. I would hazard a guess that at some stage some of that stronger competition will come back, probably not to the same extent that we had seen it, but that may not be actually a bad thing.

Mr TURNBULL—Governor, you have reminded us this morning of the way in which the Reserve Bank over the last decade or more has succeeded in meeting the objectives of monetary policy in general and inflation targeting in particular. You have reminded us that inflation has averaged about 2½ per cent over the last 15 years—I think you said—and that is right at the midpoint of the target range. You have also noted that we have had a very substantial, positive, terms-of-trade shock, a good shock but nonetheless one that has added considerably to demand within Australia. You have said on a number of occasions that, contrary to previous experiences of this kind, we have not seen an outbreak of wage inflation in Australia because, on this occasion, we have had deregulated labour markets. Could you tell the committee a little more about the importance of deregulated labour markets and the role they have played in the containment of inflation within that target band over the last decade or more.

Mr Stevens—Yes. There are a number of aspects to the way the economy is handling the current shock. It is important—and I set this out in a recent talk—that, while we are struggling with the issues we are currently struggling with, if you look at the long-run perspective, as I said
the other day, we have an inflation rate that we think will peak at four or somewhere near there, and we are concerned over how soon we can get back down to two to three. That is just night and day compared with the problems we had in previous episodes. There are a number of factors behind that. The labour market is certainly one, and I will come to that in a second. Other factors include the floating exchange rate, which does its job in helping the economy adapt to these shocks. You cannot make the shock go away—you do not want to—but you can help things adjust if the exchange rate is free to move, which it was not on some of the previous occasions where we got into trouble. I think the credibility of the macroeconomic policy frameworks, fiscal and monetary, is very important in this current episode. We did not have that to the same extent in the early 1950s or the mid-1970s or the early eighties. I think those things are very important as well.

We were talking earlier about containing inflation expectations. I will assert that I think having a credible inflation-targeting framework is part of that—so we have that now, and we did not have it in the past. That is very important. I have said before that what we have had in response to a shock whose initial impact at least is geographically dispersed—over time these differences across the economy have become smaller, in fact, because the wealth and the income spread around, but the initial shock is geographically not even, as you know—is that productive resources, labour and capital flow to the areas and the industries where they are needed. Relative wages have changed. They go up faster in mining or in the west or Queensland than they do elsewhere. That is what is supposed to happen. What is supposed to happen, if you get the textbook out, is that relative prices adjust to the shock we have had, but you contain the aggregate.

I would say that, while we are certainly watching carefully for signs of wages pressure, and many businesses tell us that they are having to pay more and they are perhaps doing it in ways that do not show up in the official wages statistics, nonetheless I think on the whole in this episode one would have to conclude on the basis of the aggregate data that the labour market has performed very well in adjusting to the nature of the shock. I do not have any doubt that a long series of liberalising changes by both sides—by governments of different persuasions—over probably 15-plus years has made a big difference to that outcome. I do not think there is any question about that. So I think the way the labour market has performed has been very important in handling the shock and, I might say, even more importantly perhaps, very important in allowing us to have an unemployment rate of four per cent. You do not get that without a well-functioning labour market.

Mr MARLES—Mr Chairman, can I ask a question about labour market reforms?

CHAIR—Perhaps, if you want to follow up on that, Richard, I can return to another question I have.

Mr MARLES—Governor, on the issue of labour market reforms, you referred to reforms over the last 15 years. Isn’t the critical reform in relation to labour market reforms the shift from having a centralised wage-fixing system to a move to enterprise based wages, because isn’t that really the basis on which we no longer have a serious fear of a wages explosion, which is what occurred in those previous economic episodes?
Mr Stevens—I think decentralisation was quite important. But I do not think I am in a position to kind of parse for the committee how much of an improvement was due to this or that particular initiative. My main point, and all I can really say to you is: if we take the labour market as it existed in the early 1980s or mid-1980s, there have been many changes since then that have made it basically more flexible and less centralised. There is actually an argument that, under certain conditions, high centralisation could be good. There is a whole debate about this in the labour market literature. But I think, for the purposes of Australia, the general direction in which that has been taken by governments over quite a long time now has been the right one. I know there is a debate about changes that are coming in now, and I am not in a position to judge, really, exactly how significant they are, at this point. But the general point is that, from the way things have gone over quite a long period, the point we have reached is a much better place than we used to be at, and that has been very valuable.

Mr MARLES—Just following on from that: you have talked about decentralising the labour market and increases in the liberalisation of it. Do you think that there is also a role, in terms of how the labour market is regulated, from the economy’s point of view, for fostering labour productivity?

Mr Stevens—There is. I would say that, as a general proposition, we are most likely to get the best productivity performance when firms and their employees are able to bargain pretty widely across the whole range of practices. That is, I think, where productivity comes from.

Mr TURNBULL—So, really, boiled down, flexibility and freedom in the labour market is good in terms of the textbook example of being able to operate to contain inflation in a period such as this, of expansion? You agree with that?

Mr Stevens—Yes, I do—and to have low unemployment—

Mr TURNBULL—Correct.

Mr Stevens—and high productivity.

Mr TURNBULL—Yes. So, on that combination you would agree with me, would you, Governor, that we—we being Australia, the Reserve Bank and governments and business—have been able to run this economy over recent years, over the last decade or more, with lower levels of unemployment and higher levels of growth and lower levels of inflation than would have been thought feasible 20 years ago?

Mr Stevens—Certainly I think a well-functioning labour market is the key to low unemployment. And it is the key to the best productivity you can find. We could debate levels versus ongoing growth rates there, but that is a secondary matter. Generally speaking, a well-functioning labour market means unemployment can be as low as possible, sustained and compatible with stable inflation. I think that is a pretty robust proposition in macroeconomics.

Mr TURNBULL—I have another question, Governor, on a more technical issue. The ABS publishes, in accordance with your algorithm, two statistical measures of underlying inflation: the trimmed mean and the weighted median. Could you tell us how those two measures are calculated, and let us have your view as to whether you agree with the views in the bank’s
discussion paper—and I recognise that it is a discussion paper and not a policy statement; this is the one written by Andrea Brischetto and Anthony Richards in December 2006. Do you agree with their view that the trimmed mean, which is a 15 per cent trim, is a better measure of the underlying inflation or the central tendency of inflation than the weighted median, which has a 50 per cent trim?

Mr Stevens—There are two questions there: how they are calculated and which is better. The technicalities of the calculations are set out in various research papers the staff have published. In essence, what we are seeking here is a measure of the central tendency of the inflation rate that distils out some of the noise that you can get. To take a current example, it is highly likely that the CPI rate of increase in the next figure that we get in about three weeks is going to be around four per cent. Is that a good guide to the ongoing trend in inflation, which is actually what we are interested in and what we are seeking to control, or not? CPIs can be and often are, and ours has been in recent years, affected by large but temporary movements in particular items. So for monetary policy we do not want to respond to those because they are only temporary; we want to respond to the likely ongoing trend. So we compute various measures of central tendency in order to try to distil that trend, as you know.

There are a few ways you can do that. You can exclude certain things from the basket on a consistent basis. It is not really fair to just exclude a few things this time and different things next time, lest you be a bit guilty of taking out only the things that are inconvenient to you. So you do need to be systematic, but there are ways of doing that on an exclusion basis. You can use statistical means to down weight or remove the impact of some of those large outliers. So you can trim off the tails of the distribution or you can take the very centre of the distribution, which is what the median does.

I have seen the views among the staff vary over the years. I have been watching these things for 15 years, I guess. At times I have heard some of them say they think the median might be better and at other times that the trimmed mean is better. So from a policy point of view I suppose I should remain somewhat agnostic and look at both and indeed not confine our analysis to only even those two. I think that is probably the wisest thing to do for policymaking. I do not doubt we have very high-quality staff and that the judgement they reach is worth careful reflection. But, as I say, the policymakers probably have to be a little wary of being tied too strongly to one single gauge and we should look at a number of them and form a judgement based on that. That would be my approach.

Mr Turnbull—How many measures of inflation do you look at?

Mr Stevens—There are a number of things that you can do. You can take out food and energy, which is what is commonly done in other countries.

Mr Turnbull—This is the CPI ex volatiles?

Mr Stevens—Actually, the CPI ex volatiles takes out some more things. It does not take out all food; it takes out some volatile bits. That is a separate one. There are various deflators that you can look at, and there are other calculations that might be done. In the end, the target is for the CPI so what we will ultimately be judged by is how that performed. These other underlying measures are a means to an end, which is to try to assess where the CPI will be over the next
several years and respond to that. Ultimately, we will be judged, as we should be, on that outcome. So there are various measures one can look at. I am a little reluctant to be tied too closely to this particular measure as the best one because I have seen those judgements change over time.

CHAIR—Before we move on to questions from David, I want to clarify something. Malcolm gave a summary of the position as he saw it in relation to your responses on the labour market issues, but I think he excluded from that summary the answer that you gave to Richard’s question about productivity. As I understood it, you responded by saying that productivity increases are best gained when employers and employees have a broader range of issues to bargain about—is that correct?

Mr Stevens—I would think that is right, yes. Why take a whole bunch of things out of the equation? Let them sort it all out as widely as possible. You have fairness considerations to keep in mind here as well, as everyone knows.

Mr Turnbull—The proposition I think I put to you, Governor—and I could not quite hear what you were saying because of the clicking of the cameras a moment ago—was that you were saying that greater freedom in the labour market and deregulation enabled the system to work so that relative wages rose but overall wage growth was contained, as has been the experience. That is the point you are making, isn’t it?

Mr Stevens—I think that, with the set of labour market arrangements that we have come to gradually over a long period, it is pretty easy to reach the conclusion that that overall set-up has worked fairly well from a macroeconomic point of view.

Mr Turnbull—We have had a long trend of labour market deregulation across governments of both persuasions, which is now being reversed, of course. But to date it has had that effect.

Mr Stevens—I will try to stay out of the political feud here, Chair, other than to say I think the argument is over the extent of reversal, isn’t it? I find it hard to reach a judgement on that but I think most macroeconomists would say the labour market set-up we have today compared to 20 years ago is much more effective in generating low unemployment and responding in a more subtle, flexible fashion to shocks. I doubt that there is a great deal of dispute about that.

CHAIR—One of the things that is being reversed is the range of issues that can be negotiated between employers and employees collectively. Is that your understanding of some of the changes to workplace laws that have been proposed?

Mr Stevens—I am not sure what you mean, Chair. Are you saying that a wider range of things are now being—

CHAIR—Yes.

Mr Stevens—If that were the case, one would not want to quibble with that trend, but I am not across the detail of the legislation enough to really comment in great detail here, I am afraid.
Mr TURNOUR—Your comments on inflation earlier indicated that you see inflation abating going forward this year. Obviously we are coming to the situation where there are some debates going on about labour market reforms. We clearly believe, more than Mr Turnbull does, that they are more flexible. Clearly the Reserve Bank is expecting inflation to abate later in the year or moving forward and that is why you have interest rates on hold at the moment. Could I interpret that to be your view of the intent of some of the changes at the moment and their potential risk to inflation?

Mr Stevens—I think inflation will start to abate, though I think it will take a while. The forecasts that we have put out have it taking some time to come back to two to three per cent. Since we made those forecasts I have begun to think it will come back a bit sooner than that, but I do not think we could credibly say it is about to start coming down very quickly very soon. I think that these things take time and that we are going to have to be somewhat patient.

We are not really in a position, in the setting of interest rates each month, to have that taken as some adjudication on labour market regulation, I am afraid. Regarding the extent to which changes in labour market arrangements affect things, it is typically not that fast moving. It emerges over time and we can take account of it as the evidence unfolds. We are not really intending that short-term decisions on interest rates be interpreted within the framework of what that says about our views on labour market arrangements.

Mr BRADBURY—Governor, I have got a couple of questions in relation to two areas, the first one being Western Sydney and the second one being skill shortages. I would like to address the issue of Western Sydney—a wonderful part of the world; perhaps in future we can have one of these gatherings out in Western Sydney. Western Sydney has been a region that has been specifically identified in a number of the bank’s statements. I know that back in the March Financial Stability Review there were references to areas of Western Sydney in particular, being identified as pockets of ‘financial stress’—that was the term that was used. Given the bank’s identification of those areas of particular financial stress, could you respond to this question. I will be specific about what I mean. I am referring to the cycle since the time when the bank identified Western Sydney as a particular area of concern, so March last year, and since that time there have been four increases in the cash rate. Could you indicate whether or not the bank is concerned that that latest cycle of tightening, which has obviously been directed towards slowing aggregate demand, has also pushed many families struggling financially in Western Sydney beyond the economic precipice? Is there any particular impact on increases to mortgage defaults, arrears and home repossessions?

Mr Stevens—It is quite right that in much of our material we have taken note that the areas of greatest concern from an arrears point of view tend to be—not entirely, but there is a heavy concentration—in Western Sydney. There are a range of reasons for that which we could discuss if you want to, but that is a fact. We are certainly conscious that, when we raise interest rates, it is not sufficiently precisely targeted to not impact others. We cannot finetune it—that is right. So we are certainly conscious that some of these people will really struggle. I know that is true. We have an aggregate instrument that has to be geared to aggregate conditions. Certainly in aggregate, the arrears rates on mortgages in Australia are very low and, indeed, they have fallen a bit in the second half of 2007. I do not think they have got any worse either than they were in the western suburbs of Sydney over that time.
It is also the case that the economy of New South Wales has picked up some speed over the past year, which I think will probably help those people, at least to some extent. That is part of the diminution of regional differences that I referred to in the opening remarks. So, yes, I am aware of those problems. We certainly are conscious of that and conscious of the need to not inflict any more pain on these people than is absolutely necessary, but in the end we have to make an aggregate decision for the economy as a whole as best we can. That is, I guess, the best way I can respond to your query.

Mr BRADBURY—So are we saying that there may be collateral damage in dealing with a broad and blunt aggregate-based instrument in monetary policy?

Mr Stevens—I would not use the term ‘collateral damage’, but I know that people are affected by higher interest rates. We have to have some effects. We have to slow the economy down to some extent—that is a reality. I do not have an instrument that only affects some people and not others, and neither does anybody else.

Mr BRADBURY—I perhaps quibble with that point, but isn’t that also a further reason why an appropriate and complementary fiscal policy, particularly for tightening results from targeted cuts in government expenditure, might also be a tool that might not only address issues of overall demand—

Mr Stevens—I would not argue against some role for fiscal policy at all. It is not my place to give advice on it. If people propose particular fiscal initiatives that are complementary, well and good, that is just fine with me, provided that we remember that even fiscal measures are going to have to produce a slowing in demand—the same size slowing in demand as what we are looking at. There are no two ways around that issue. It will probably prove pretty difficult to have really finely calibrated fiscal measures, but I could be wrong there; I would be happy to be proved wrong.

Mr BRADBURY—Would you agree that there is a greater capacity to do that than with monetary policy, particularly if we are looking at targeted expenditure cuts?

Mr Stevens—There is a greater potential capacity but, while I am not an expert in fiscal matters, I would hazard a guess that it is not all that easy to do. I could be wrong about that.

Mr BRADBURY—If I can just turn to—

Mr MARLES—Chair, I have some questions.

CHAIR—They were follow-up questions. Mr Bradbury indicated at the start he had a couple of questions, one in relation to Western Sydney and a series of questions in relation to skills.

Mr PEARCE—We all have a lot of follow-up questions.

Mr MARLES—Before we go on to skills, can I ask a question on mortgage stress.

Mr PEARCE—Another follow-up question.
Mr MARLES—We are on the issue of mortgage stress and I just wanted to follow up on that. I am sure, Mr Pearce, if you have questions about mortgage stress you will ask them as well. Governor, has the Reserve Bank done any research work in regard to mortgage stress in Australia in terms of how many households are experiencing it and particularly what kinds of households they are? What are the characteristics of the households which find themselves in those circumstances?

Mr Stevens—We have had a look at some of the measures because this is a topic of considerable public attention. I suppose the first thing to say is that I think in some of the public discussion the term ‘stress’ has become much more loosely defined than it used to be. I have seen in a number of cases references to people being in stress, so to speak, if they spend more than 30 per cent of their income on housing. The original definition was a bit narrower than that. It was if you were in the bottom 40 per cent of the income distribution and you spent more than 30 per cent of your income on housing. I think that is a more useful definition. Someone on a very high income who has chosen to have a very large mortgage and still has a lot of money to live on after that could technically be defined as ‘in stress’ if you just used the 30 per cent rule, so I do not think that is very useful. That is the first point.

In addition to that, there are a number of things going on. Let me state at the outset there is no doubt that there is a significant number of people who are feeling pressure. There is no question. I would not want to resile from that fact at all, and there are more of them now than there were a year ago, at least as a result of interest rates rising. That has to be true. But a number of things have happened in the housing market over the last 15 years. One of them is that the availability of finance has become much wider. As we were saying earlier, at the moment there is a bit of a diminution in competition, but the long-run trend is that it has been much easier to get money.

I think there has also been a trend for the community as a whole to be more affluent, and I think with that has come in large chunks of the middle classes, I would say, a decision to spend a higher proportion of income on housing, just as they now have to spend a lower proportion on some other things like manufactured goods, whose prices have fallen, or food. As you get more affluent, some of the necessities take up a smaller share of income and some of the things you really want take up a larger share. That, I think, has led to a choice by many people to put more of their income into housing. That is not stress, per se; that is a choice that has been made. In trying to work out who really is stressed, I think all these trends kind of complicate the figures. So I think that makes it hard. But, yes, there are people in mortgage stress; there are people in rental stress too. I am conscious of that. There always has been a significant share of low-income people in that position and there is a somewhat higher share of them just now—that is right. I do not really think I have any more observations I can make on that.

CHAIR—Is there a follow-up from the other side? We have started to develop a pattern here where we are starting with the labour market questions. There is a bit of back and forward in relation to the subject matters, and I do not think that is inappropriate, but in terms of fairness I think Peter may have had follow-up in this area first.

Mr DUTTON—Governor, I wanted to ask some questions about the emissions-trading scheme, but before I do that I would like to stay on this topic. When people talk about a ‘soft landing’—just to clarify this issue—people are talking therefore about growth coming off and
unemployment going up. How high would unemployment have to go and how many people would have to lose their job—

**CHAIR**—I do not want to interrupt you—we are going to come to you for questions. I am just asking if you wanted to say something in relation to mortgage stress before we move on.

**Mr DUTTON**—Well, if people do not have jobs then they cannot pay their mortgages. I guess that was a link that I was making. So I would be interested to hear the Governor’s response.

**Mr Stevens**—I am not sure that I would say the unemployment rate has to go to some particular number as part of what we are trying to achieve. What is clear is that five per cent plus demand growth cannot be sustained. That has to slow down. GDP growth will slow, and that is in our forecast. Employment growth will slow as well.

The extent to which unemployment would rise depends on a range of other factors, not least of which is how flexibly and quickly the labour market responds to the slower growth in output. In principle, that response could be very rapid and unemployment would barely rise at all. But, if we are honest, I think we have to accept that through periods of history where you have a mid-cycle pause in the growth trend, which is what we are talking about here, the unemployment rate goes up a bit for a while and then it starts to go down again.

I do not think there is any sense in which one should say that a much higher rate of unemployment would permanently be needed to contain inflation. That is not the macroeconomic framework that most of us are working with. Most of us are working with a framework where there is no long-run trade-off between unemployment and inflation. There is a short-run inverse relationship most of the time, but to contain inflation does not require the unemployment rate to permanently be high, as far as I can see. That is not to say there is not some temporary rise for a while. That is what has occurred in previous mid-cycle pauses and that is what we have said in our SMP, I think. It actually says that—is that right, Malcolm?

**Dr Edey**—Yes, that is right.

**Mr Stevens**—So that is not a new thing for us to say. That is the best answer I can give, I think, to your question.

**CHAIR**—Before we go back to David, I know there are a couple more issues, at least, from the government representatives’ side to do with mortgage stress. The *Four Corners* program that was on on Monday night went through a range of lending practices that were dubious, to say the least, in terms of the pressures that they put on particular groups of people. Does the Reserve Bank have any view in relation to those lending practices? Perhaps in your response to that, you could make some comment in relation to the Henderson poverty index, its appropriateness and the appropriate use of it by banks.

**Mr Stevens**—Unfortunately I have not seen the program, so you have got the advantage of me. I was hosting a dinner for the board in Melbourne on Monday night so I did not see it and I have not seen a recording of it. I think a couple of my colleagues have seen a recording, so I might get them to address some of the issues that were raised there. My general point is:
you have got a highly competitive mortgage market and you have got fringe lenders coming in, you will get some practices that should not occur. The worst, most egregious, examples of that are the ones we saw in the US, which is why we do not want to go, as I said earlier, in that direction. But, not having seen the program, I cannot really comment specifically, I am sorry. Ric, I think you might have seen a recording of it. Is there anything you want to say about those specific instances?

Mr Battellino—Over the past couple of decades, as Glenn has mentioned, we have moved to a system where finance is readily available in the community. That is in marked contrast to where we were in the 1970s, where basically the average person had a great deal of difficulty getting money from a bank. In the current system the onus is more now on the individuals to be careful about accessing finance. Thirty years ago, basically it was less likely that people got themselves into trouble, because money was not available. I have seen the program. It is hard to draw general conclusions from a program like that, because, in the end, there were very few people on that program. There is no doubt that in a community of 20 million people there are going to be some people in trouble. But looking across the whole economy the figures show—I think our calculations are—there are 15,000 people in the whole of Australia who are running 90 days overdue on their housing loans. The aggregate figure is not a lot of people and, as Glenn said, recently it has been coming down again.

One of the advantages of the current turmoil that is going on in markets is that it actually cuts back on some of the practices that were growing. That has been said in the US. They got to the stage where there was a lot of abuse of lending. Here in Australia that never developed, but I think it was growing. One of the practices that I think is quite dangerous is that lenders have started using agents to market loans. There is no doubt that the agent does not have the same incentives to maintain high standards as the bank itself. I think it is very important for banks to maintain a direct relationship with their clients and not to use agents. I think it is very important that individuals who are licensed to be agents meet very strict criteria and are highly qualified, because they can do a lot of damage by inappropriate selling.

So it is hard to draw general conclusions but, at the macro level, defaults and arrears on loans are at record lows. There is no doubt, as I say, that across the whole community there are going to be some people who are in trouble, but at that level the problem is less than it was in the past.

Mr Turnbull—I have one question about housing which directly relates to this. I will address it you, Governor, but you may prefer your colleagues to answer it. You and your predecessor, and the bank overall, have spoken a lot about housing affordability in the past, which of course is at the core of the housing stress issue. We saw a very familiar graph only last week—I think it was in Anthony Richards’s paper that he gave to the Melbourne Institute’s Australian seminars—showing how since the late 1980s housing prices have decoupled from consumer price inflation, the construction index and most other mainstream measures, and have gone up. Apart from a short blip, they have continued to head up pretty solidly. So we have seen asset inflation there, and the question is: why is that so?

The banks historically have always taken the view that this is in very large measure a supply-side problem; that we are simply not building enough dwelling units—houses and apartments. Could you let us have your current perspective on that, because we have seen an interesting example in the United States where there has been big asset inflation in houses and now a big
fall. In some markets house prices are down by as much as 20 per cent—10 per cent on average nationally. What is your current view on that?

**Mr Stevens**—I do not think there is any doubt that the big problem of affordability is not that interest rates are too high. They are above average at the moment, but that will be for a while until the job is done and then they will be normal again. The big problem is that the prices are very high. We have very high prices in Australia relative to income. I think there are probably both demand and supply elements to that story, if you take a 15- to 20-year view. The availability of finance and the big decline in nominal interest rates when inflation came down meant that people who would have liked to have afforded better quality housing than they could have, now could. So demand rises and, in any short period, there is a finite stock, so the prices rise.

But then the question is: why over time couldn’t we have had a more elastic supply of additional dwellings—the marginal addition to the stock? With harbourfront land, there is only so much; it is going to be expensive and the more so as people get more affluent. In a sense there are only so many of those houses to be afforded so the affordability of those has to move such that the number of people who can afford them is equal to the number that there are. There is a question though as to why in the other parts of our cities it seems quite expensive, in some cases anyway, to add the additional stock that might be much more affordable for people to expand into. I think we have probably got to conclude that there must be things happening on the supply side there that matter considerably for those outcomes.

So I think you have got both demand and supply; it depends which areas you are talking about and over which time horizon. But I think that with these supply things, the more time goes on, the more it seems to me that it becomes more apparent that there are issues there. On the comparison you made with some other housing markets in other countries, it is important to remember that a big difference between ourselves and the US is that they have got a very large stock overhang—they built too many.

**Mr Turnbull**—Yes.

**Mr Stevens**—We do not have that problem—if anything it is slightly the reverse, and construction will pick up in due course because of that. That is a major difference between the prospects for those two markets, I think. You were not suggesting otherwise, but it is probably worth getting on the record that that difference is there.

**Mr Turnbull**—Governor, if I may just add to that, I think what we have seen in the United States is that supply has kept up with demand. Over the last few years demand has been fuelled by very aggressive subprime lending. That lending has now come to an end and so you have as a consequence a very big overhang. On average, December to December, there has been a 10 per cent decline in house prices across the United States.

**Mr Stevens**—Yes.

**Chair**—We are only five minutes away from a 15-minute recess. At this stage it is probably appropriate to indicate that there are three school students who have questions for the Governor. I invite Miss Afiyat Mustaq to ask the first question.
Afiyat Mustaq—The question I would like to ask on behalf of East Hills Girls Technology High School is: what level of importance does the Reserve Bank of Australia place on the rising Australian dollar in relation to its impacts on the domestic economy, and what is the Reserve Bank’s policy on the rising Australian dollar?

Mr Stevens—Should I answer these questions sequentially or collectively?

CHAIR—Take them one at a time.

Mr Stevens—that is a good question. The exchange rate has gone up, and that is an important part of the system: it helps the economy cope with the big rise in commodity prices that we have had while getting less inflation and helps us control inflation—though it does have some impact on exporting industries and those who compete with imports. Our policy in Australia for many years now has been to have a floating currency—we have had that for about 25 years. By and large that has worked very well, and I think it is still working pretty well for us. So our policy is to let the exchange rate go up and down as the market sees fit.

Ardi Astarto—Good morning. In an article published in the *American Economic Review* in 1995 the economist Carl Walsh argued that governments should impose a personal financial penalty on their central bank governors if they failed to meet their set inflation targets and that the further the actual inflation rate is from the target the greater the penalty should be. This idea is supported in principle by the current governor of the US Federal Reserve, Ben Bernanke. Do you support or are you opposed to being made accountable for your decisions in this way?

Mr Stevens—that is an interesting proposition. To my knowledge no country has actually implemented it—that could be because central bank governors cannot actually control inflation exactly over short periods; there are other things that impinge on it. It could also be that you do not actually want the governor to try to control inflation too closely over a very short period; otherwise you may find that the rest of the economy is swung around more than it needs to be. So that is why our system is actually for a flexible target that lets us bring inflation back on course gradually so that we do not do too much damage to other things in the process. As for my own remuneration, that is set by my board, and I gratefully accept whatever they choose to give me.

Anthony Markakis—Good morning. I am representing the year 12 economics students of Newington College. The question on behalf of my colleagues is as follows: how have the Reserve Bank’s perceptions of the non-accelerating rate of unemployment, in other words the NAIRU, changed in recent times, particularly since unemployment has been under five per cent for some time now? To what extent, if any, is it considered when making monetary policy decisions?

Mr Stevens—that many more people know what the NAIRU means now than used to be the case. This is a technical economist’s term that I am still getting over the shock of seeing so commonly used in public debate. The NAIRU, or what some people used to call the natural rate of unemployment—and that is a bad term because there is not necessarily anything natural about it—is an analytical construct, which I think was useful in theory to get across the idea that there is no long run trade-off between inflation and unemployment. As I was saying earlier, there is a short-run relationship but in the long run there is not. The sustainable unemployment rate is set
by other things, mainly I think in labour market arrangements. So it is a useful analytical construct in theory. Attempts to put a number on it, I think, are fraught with difficulty. I would offer the observation that, as time has gone on, the empirical estimates that have been made tended to come down, just as the actual unemployment rate did. I think the empirical estimates of many years ago would probably be surprised, confounded even, by the extent to which quite low unemployment has been consistent with price stability in recent years. So it is a useful analytical idea in theory, but hard to put a number on and the numbers tend to shift—and we do not have a doctrinaire view about what the NAIRU is, if it exists. It is not a prominent device in the setting of monetary policy, as Ian Macfarlane, my predecessor, made clear over the years, and I agree with him on that. Thanks, but good question.

**Proceedings suspended from 10.32 am to 10.49 am**
CHAIR—We have at least two more questions on mortgage stress. Peter wants to ask his question first and then Sharryn. When we have done that we will go back to the questions that David was asking.

Mr DUTTON—I have a follow-up question which is again about interest rates, mortgage stress and related factors. My attention was drawn to some of the comments made by the chair in a doorstep interview. There was a suggestion that only one side of politics in this country was concerned about the struggle that many families are having, which of course is an absurd proposition. Following on from some of the deputy’s questions, what are your comments on where you see the space in relation to regulation or the stance the government should be taking on mortgage brokers and agents of banks, and some of this which some people might suggest have lesser lending practices than others—obviously, there are counterviews to that. What are your comments on that?

Mr Stevens—I think there is a question to be asked about the regulation of mortgage brokers and those sorts of organisations. Phil, perhaps I could get you to say what the state of play is on that. There has been quite a long-running discussion about this at the state level.

Dr Lowe—This process has been going on for at least five years with the states and the Commonwealth discussing how regulation and mortgage broking should best be done. Late last year the state based group put together a proposal that would be implemented. My understanding is that, at the recent COAG meeting, it was agreed that that would be taken over at the Commonwealth level, which seems like a very sensible thing to do. Uniform national regulation of mortgage broking would address the licensing requirements and provide a dispute resolution mechanism and many of the other things that would go in as part of a regulatory environment. There is a broad consensus in the industry that that needs to be done. I think the sooner it gets done the better because, as Ric said, in some cases there has been rather poor advice from the brokers to the borrowers.

CHAIR—Sharryn has a question on mortgage stress. This topic is probably going to take a little more time in the next bit of the hearing.

Ms JACKSON—Governor, I think I understood what you were saying about the bank having a narrower definition of mortgage stress. But I was not sure whether you had answered the question about whether the bank itself had undertaken any recent work on mortgage stress or had a figure or an estimate for the number of households in mortgage stress.

Mr Stevens—I did not say that the bank itself has a narrower definition. What I said was that the usual, and I think more useful definition, is a bit narrower than we often tend to see. There is a tendency to try to exaggerate the number of people under real stress, which is unhelpful because it distracts attention from those who really are under stress. So the point about definitions was that some care is needed. Malcolm, I do not know whether we have research that we have done on this that we are intending to publish. There was a speech by Tony Richards, a week or so back, in which he looked at affordability—which is related but not exactly the same. I do not know whether there is publishable research on stress per se forthcoming. Malcolm, can you answer that?
Dr Edey—We have published various bits of analysis on the question of who has the housing debt and how that correlates with different levels of income and household characteristics. Some of that is published in articles in our bulletin or in the Financial Stability Review. Generally what that shows is that, at a very broad level, the people who have the debt are mostly the people who, you would expect, would be able to afford to service it—that is to say, people with high incomes. But, as Mr Battellino was saying earlier, if you look at more tightly defined measures of stress like numbers of households in mortgage arrears, you do identify numbers of people who are subject to that—I think the figure there was about 15,000 households in arrears.

Ms JACKSON—Where I am specifically trying to take my question is whether, as is my perception, there is a greater recognition of the household sector debt per se. If so, is the bank more sensitive to that in this current tightening cycle than in previous ones?

Dr Edey—We know that household debt is going up; it has been going up for two decades. It is now about 160 per cent of household income in aggregate and still rising, and that does mean that any given interest rate move has a bigger net effect on the amount of income available to households after interest. So we are well aware of that trend. Having said that, though, I will say that the last year or so has been a period of very rapid growth in household incomes overall, so that even when you allow for the additional amount that is going out in interest payments you still have a very high level of real income growth for the household sector as a whole.

CHAIR—I think we have just about finished on this topic, but Mr Keenan has a question in relation to it as well.

Mr KEENAN—It is not in relation to this topic, actually, Mr Chair. It is in relation to a totally different topic.

CHAIR—Well, we will come back to that, then. If we have finished on this topic, we will go back to Mr Bradbury’s question in relation to skills.

Mr BRADBURY—In relation to skills shortages, I note that, in numerous statements that the bank has released, skills shortages and the lack of suitable skills being available for positions in demand have been something that the bank has consistently made statements on. I note that on 4 March 2008 there was a statement that referred to shortages of suitable labour persisting. This is not something that has just emerged on the radar. I wonder, Governor, if you could give some indication of the background which has given rise to commentary from the bank on the issue of skills shortages—for example, when did it first emerge, as far as the bank was concerned, that this was a potential threat to the economy in the current economic cycle?

Mr Stevens—Firstly, let me say that I think it is not just skilled labour that we are talking about. My reading of what we gleaned from the talks that our staff have with businesses each month is that it is just shortages of labour generally that are, in some surveys, the biggest single impediment to an expansion of business operations. The theme of capacity constraints—of which this is one, and of course there can be capital capacity constraints as well—is one that I think, we have talked about for several years. That is not surprising, because the economy has for a few years now been approaching a point where the level of utilisation of labour and capital is very high, and that has been consistently so. We have, over a few years, made references to capacity constraints, which all economies ultimately have. I cannot give you chapter and verse.
on what was the very first time that we uttered those words, but I think it was a few years back. It is a reasonably longstanding feature of the economy as we perceive it, and in a sense it is the feedback that the firms we talk to have been giving us.

**Mr BRADBURY**—We were briefed today by a market economist who indicated that he characterised skill shortages—as opposed to shortages in general—as being severe. Would you subscribe to the use of that expression?

**Mr Stevens**—Central bankers rarely use adjectives quite that strong!

**Mr BRADBURY**—You are amongst friends.

**Mr Stevens**—There is a survey of firms that I have a picture of in my mind, where—which of the surveys is it, Malcolm?

**Dr Edey**—It is the NAB survey.

**Mr Stevens**—It asked businesses to rank what it is that is preventing an expansion: demand, finance, government red tape, interest rates or whatever it is. The No. 1 answer, if I remember rightly, is shortage of labour.

**Dr Edey**—The Sensis survey also shows that.

**Mr Stevens**—Whether that qualifies as severe, I do not know, but I think it has been a significant feature of the economy. We are as fully employed as we have been for 30 years. That is actually a good problem to have in a very important sense, but it is obviously an issue that we have to watch very carefully from an inflation point of view. That is basically what our story has been.

**CHAIR**—We will go to Michael now for some questions.

**Mr KEENAN**—Thank you very much, Chair. I note that I have been very happy to wait for your call to ask my questions, as has been the practice in the past. Governor, in the bank’s forecasts published in the monetary policy statements of February, May and August of last year, the bank forecast inflation to be between 2½ and three per cent throughout this year, 2008. But in November of last year the bank revised its forecasts and they did the same in February of this year. I think we are all aware that market economists and, very importantly, the Treasury, mirrored those changes in forecasts. I would be interested in what factors in particular have led to this revision, particularly the revision of the forecasts in the last two statements that the bank has issued.

**Mr Stevens**—Let me begin on that and perhaps I can get Malcolm, who is the custodian of the forecasts, to elaborate. In any forecasting exercise, the evolution of history obviously has to have some impact on your assessment of where we are going. I do not think it is any secret that the last consumer price index data and the underlying measures with it were a bit troubling. I do not think you could look at that data and not revise up. The bigger story, I suppose, is that, as I set out in my opening remarks, in 2007 we saw demand growth pick up early in the year, and that was sustained right through. We began to basically feel more troubled about the likely inflation
effect of that as time went on, and the forecasts gradually came to reflect that. I guess that in simple terms is the story. Do you want to add to that or indeed contradict it, Malcolm?

**Dr Edey**—I will not contradict it.

**Mr Stevens**—I am relieved!

**Dr Edey**—The position is that for quite some time we have thought that inflation was likely to be relatively high, by which I mean above 2½ per cent, which is the centre of the target range. During 2006 we were forecasting essentially that inflation would be in the upper half of the target range at the end of the forecast period. That was the consistent position through 2006.

In early 2007 we revised that outlook downwards, essentially as a result of getting some weaker than expected CPI outcomes. We took the view that was evidence that the economy had a greater scope to grow without generating inflation pressures and we started to build that into the forecast. There were actually two lower than expected CPI outcomes in a row and in response to both of those we successively revised down the outlook. That was the position up to the time of the May statement last year. Subsequent to that, each of the next three CPI outcomes were higher than expected and we responded to that by revising up our view of the short-term inflation trajectory.

**Mr KEENAN**—If I cast my mind back to the last time the bank came before this committee in August of last year there has certainly been a marked change since then. Does the bank feel that it has been taken by surprise by events since then?

**Mr Stevens**—I think we had just lifted interest rates as of that August hearing. I think it is reasonably clear from what we had said at that time that abatement of inflation pressures was interesting, a bit of a surprise, it was good, it probably will not continue and inflation probably will rise again at some point. We said that if that looks like it is starting to occur, we would have to respond. Indeed that is what occurred and that response had already begun at the time of the August hearing. Of course it has continued since. Would I say that I am a bit surprised by the strength of demand in the economy through last year? Yes, I would say that. We did not predict a weak economy, but we did not predict it to be quite as strong as it turned out. More generally, this process is always going to have some surprises, there are no two ways about that. We should not be shy to admit when things are unexpected and I think we have been honest enough on occasion to say, ‘That result was unexpected, here’s what it means and here’s how we respond to the extent to which the unexpected thing affects the outlook.’ That is all we can do.

**Mr KEENAN**—Would you draw any lessons from the experience?

**Mr Stevens**—It is the same lesson we already knew from having been a maker or a user or observer of forecasts for 25 years which is they go wrong. The extent of forecast errors we are talking here are very small by the standards of plenty of things I have seen, believe me. I think policy makers know that. They know that we have very capable staff, they give us their best guess and then we have to ask: ‘Could they be wrong? If they are what happens?’ And so on. That is part of the policy-making process. Another part of the process is that you know that with the best endeavours the future is unknowable, it is uncertain, forecasts are imperfect and they
always will be. I would draw that lesson and that is of course not a new lesson but one that we should certainly remind ourselves of from time to time.

Mr PEARCE—In relation to these forecast issues, as is somewhat obvious, monetary policy utilises the use of interest rates in order to slow growth and demand. Clearly, there is a lag between when the decision is made to lift or reduce interest rates and when that effect takes place in the marketplace. When do you believe will be the right time to reduce interest rates before unemployment spirals out of control and in fact the economy dips further than what is in everybody’s interests?

Mr Stevens—That is going to be a very important question. I am not sure that I can foreshadow here today at what moment we will reach that decision, but let us say a bit about the lags. It is true that there are substantial lags, and we are conscious at each point when we make decisions that the effects of earlier decisions are still affecting the economy. It is not that nothing happens for quite some time after you make the decision; things start to happen pretty quickly, but the effects build and accumulate. That is the sense in which there are lags. So that is something that we always are trying to keep in mind, which is why typically I am, at least, keen to move in relatively small increments, for reasons to do with that.

I cannot tell you at what point rates can start to come down. I cannot even promise really that they might not rise again. I think for the time being this is the right number, but that is an assessment obviously we make every month, as is our job. What I can say is that I think the current level of rates, as we have made quite clear, is on the high side. At some point in time, they can be lower. When they have done the job, they can come down. We do not wait to conclude that the job is done to the point where inflation itself has actually gone all the way back down to the target. What we are trying to do is get to the point where we are fairly comfortable that that is going to occur, and then we can start the adjustments occurring. When will that be? I cannot tell you that at the moment, mainly because I do not know, though probably it would not be appropriate to foreshadow anyway—but I do not know the answer at the moment. All I can do is describe the way that the system works, and that is how it will work. That is how it has worked in the past.

Ms JACKSON—Can I just follow up, given the earlier questions on the forecasts for inflation last year. It seemed apparent that the economy was close to capacity in 2006-07, and I guess you assume, given that the bank raised rates three times—was it?—in 2006 and a couple of times in 2007, that the inflation indicators then were on the upside, at risk. Would that be fair?

Mr Stevens—Yes. I think that is a fair statement. The history here is as Malcolm described it: we raised rates three times in ’06. The level we had reached at the end of that ’06 year was the previous peak for the cash rate. We then got a couple of quarters where the inflation rate actually came down—it was not rising; it was falling—and our response to that was: ‘You have to acknowledge that they’re the facts. That probably won’t continue, but we’ve got at least some time to assess developments.’ So we held for a while, and then we started to go up some more when the demand data and the price data started to tell a more consistent story than they had in that earlier phase.

Mr MARLES—Governor, I want to ask you about what is happening in the US economy but, before I do that, I want to return to the skills issue. It seems to me that you really say that the
issue is a shortage of labour, but, in the statement on 4 March 2008, you talk about an absence of suitable labour persisting. What do you mean by ‘suitable’?

**Mr Stevens**—‘Suitable’ as defined by the firms who tell us that that is what they are short of. There is no doubt that there is a skills issue there, but my understanding of the feedback that we get is that it is not just confined to the highly skilled.

**Mr MARLES**—That is part of it.

**Mr Stevens**—Sure.

**Mr MARLES**—The main question I want to ask you, Governor, is just to get your take on what is happening in the US. Is the US in recession, in your view, and is the credit crunch domino going to dampen the US recovery? Coming from all of that, I guess: what implications are there for our economy?

**Mr Stevens**—The question on everybody’s lips is, I suppose: are they in recession? If the Fed chairman is saying there will be little growth if any, who would I be to differ—he is closer to it than me. So I think the answer is that, if it is not actually a technically defined recession, it is close enough to it that we should not bother arguing about: is it or isn’t it? It is very weak. It is certainly feeling like a recession even if it is not one. That is what is important. We have been assuming that is the case in the US for a little while now.

Will the credit issues delay recovery? It is certainly the case that, if you look at other episodes of history and the history of other countries, when you have these severe credit impairments it usually does complicate the process of getting recovery. I think the Americans, being the sorts of people they are, tend to get on and fix problems pretty quickly. We could contrast that with some other countries who languished under serious asset price and debt problems for quite long periods. Americans will get on with it, but, that said, these things are not easy to deal with. I think, as Chairman Bernanke said, there is considerable uncertainty surrounding the forecast that the US economy will start to resume growth later on this year. I think that is inevitable.

Implications for Australia: we have already factored into our outlook the assumption that the US economy has no growth or even a slight contraction in 2008, first half. What that means for us is in part addressed by asking what it means for other countries with whom we trade, and I covered those issues in the opening remarks. Much of Asia continues to be pretty solid. There is a trade linkage there to the US, but the real question is the extent of financial contagion on them. That to date I think has been confined to share prices falling, which is not unimportant, but the banking systems are okay. For Australia, we have to be cognisant of the possibility of a tightening of credit conditions here. At the moment we think that what has happened is the capital markets have stopped providing as much finance but the banks have picked up the difference, approximately speaking—not exactly but roughly speaking. I think that is what we need them to do.

Going forward, we need to obviously keep in mind the possibility—I would not say probability necessarily—that they find that harder to do if the international crisis goes on. But so far they have done well I think in funding, and they are in a strong position so that is a good
starting point for us. Obviously, these are things that we watch very closely every month. Is there anything you want to add to that on the US or credit, Guy?

Dr Debelle—No.

Mr DUTTON—I just want to touch on the issue of an emissions-trading scheme, as I foreshadowed before. I want to turn your attention to Ross Garnaut’s paper, where he says:

The impact of introduction of the ETS—

or emissions-trading scheme—

is large enough to have implications for macroeconomic stability.

He went on to say:

The direct price effects—

of the ETS—

will be substantial.

Does the bank agree with that, and what might some of the implications precisely be as a result?

Mr Stevens—I do not know that there is much precision here at this point, because obviously there is much more discussion to go on about Professor Garnaut’s report, and something presumably will be implemented at some point. The Reserve Bank has no role in any of this climate change issue. We are not involved in policy advice or formulation in any way. But let us suppose, for the sake of argument, that there is at some point a set of policies which increase the price of energy. At a first pass, I would expect that the way we would think about that from the point of view of the inflation target would be roughly the same as the way we thought about the GST when it came in. In that episode, there was a quite large one-time rise in the price level. Some prices rose, others fell, but the net effect was positive and the CPI inflation rate went to six per cent. But it was a one-time level shift; it was not an ongoing inflation effect, provided there were no second rounds—which, of course, we have to watch for. But, on that proviso, then what we do is we look through that, and that is what we did on that occasion. If it were the case that policies to address climate change had an impact of that type, even if the quantity were different, at the moment I cannot see why we would not treat that in the same fashion. The harder thing, I suppose, would be if there were smaller increases over a whole run of years, little bit by little bit. It gets harder to distil that out.

Mr DUTTON—And that is more likely, you would have thought.

Mr Stevens—I suppose it is. The best I can tell you is that, to the extent it is possible, a change in the relative price of energy should not be thought to lead to higher ongoing inflation over time. If we are reasonably confident of that, then we do not respond to the policy measures to bring in those relative price changes, at least in principle. It will of course be hard, as you say,
to actually do the calculations, but I think the right analytical approach is to try to extract from that as best we can. I cannot really say much more, I do not think.

Mr DUTTON—Has the bank done any economic or other modelling around this particular issue? The reason I ask that is that the point you make is that the GST was a one-off rise, and the likelihood under a trading scheme is that there would be a series of adjustments until the equilibrium was reached. If there were inflationary pressures that came from that—people were paying higher energy and petrol prices—what alternative would the bank be left with?

Mr Stevens—Presumably the intention of these policies is to shift relative prices in order to affect behaviour to reduce consumption of energy—or at least those forms of energy. But the intention of these policies is not to engender a continuing higher rate of inflation, nor would the community want that. So our job is to face these shocks as best we can and try to preserve price stability over the medium term, which does not mean necessarily that, the moment there is a rise in energy costs, we kind of rush in and bang the economy on the head to stop that. I do not think we would do that. We would try to form a medium-term view and watch for second-round impacts. One of the things the community will have to accept in that world is that this is a reduction in living standards insofar as our purchasing power over energy-intensive things is concerned. We have got to accept that. If we were to try to collectively push up our wages to get that back, that actually would defeat the intention of the policy. Obviously that would present a second-round problem for us if that occurred. If the policy is well explained, then that need not occur, but that will involve people accepting that there is a living-standard reduction in that sense associated with this, it seems to me. Do you want to add anything to any of this, Malcolm?

Dr Edey—I do not think so.

CHAIR—Richard, you have a follow-up question in relation to that?

Mr MARLES—Yes. I am interested in Peter’s question on climate change because it is one that occurred to me when I was reading through the papers, particularly in terms of the statistical methods that are used to work out underlying inflation. One of the examples used was in relation to Cyclone Larry and the effect that it had upon the banana crop and what that did to inflation. It had me thinking that Al Gore, of course, would say that cyclones, like Cyclone Larry, are going be more frequent events in terms of climate change. Is that something that you are talking about? Are the economic impacts of climate change something that forms part of the discussion at the Reserve Bank?

Mr Stevens—To be honest, it does not form any significant part of the month-to-month decisions. We have on the board, as you know, Warwick McKibbin who is a world-renowned expert in some of this modelling work, so I think we are well placed, if we need discussion of these things, to be able to do that. But, really, climate change in geological time is happening quickly but in monetary policy time it is happening, I think, sufficiently gradually that it does not impinge on our month-to-month decisions. If it turns out to be the case that there are more cyclonic events and we get repeats of these sorts of things that, say, push food prices around, that is mainly a volatility question, and that is why a medium-term target, the ability to look through temporary shocks and the use of underlying measures to detect the ongoing trend are all useful. But that can be handled, I think. The real economic implications of climate change are probably not in the monetary policy area, I would say.
Mr TURNOUR—I come from Cairns and, having the Great Barrier Reef and wet, tropical rainforests, obviously climate change is a major concern, economically as well as environmentally, in my part of the world. But would it be fair to say—and I understand that you have made some comments about whether or not it fits into monetary policy—that having an economy where price signals directly represent or better represent the actual impacts of different activities, whether that is in the energy area or other areas, is going to aid the role of the Reserve Bank in the longer term, in terms of managing the economy, when the economy is effectively pricing in a real cost, whether that is from pollution or other areas?

Mr Stevens—I do not want to step very far into the climate change area because it is outside my field of expertise, but I think most economists would say that, if our society has decided that climate change is something we need to deal with, then listing the price mechanism as part of the solution will be critical. In fact, I think most economists would say, ‘If you don’t do that, you won’t really get a full solution.’ In an economy where price signals work, it is generally—from any policy perspective, I think—desirable. It functions better and leads to higher living standards in the long run. That would be a general position which I think could be applied in this instance.

CHAIR—Sharryn, do you have some questions?

Ms JACKSON—Yes, and I should preface them by saying I am a Western Australian and already believe that we are the engine room of the economy. There are and have been a number of constraints in the Western Australian economy, particularly with the provision of infrastructure, which have resulted in some substantial public expenditure. I note you have referred to that in your statement. I guess some people assert that that sort of spending, which has often involved state governments going into debt, is putting greater pressure on inflation. Is that something that you would agree with?

Mr Stevens—This returns, I suppose, to an issue that this committee, in its previous incarnation, looked at a number of times. Demand is demand and, whether it comes from the public sector or the private sector, productive resources are used to fill the demand. Investment, of course, creates new capacity for the future, which is good, but it does use productive capacity now in order to do that. So, in that sense, that demand, like private-sector demand, adds to the pressure on the economy’s productive resources.

As for the debt per se, it is relatively easy for governments in Australia to fund the things they need to spend money on. If they do not have the current revenue, it is not very hard to borrow; credit ratings are high and financial structures are in good shape. So that is not the issue. The question in recent times has been finding the real resources when you go to spend the money. Public spending has increased strongly, as has private spending. As I said at the beginning, that is really only part of expenditure, domestically and when we look at the big aggregates, that has not been quite as strong in the past year as housing construction or dwelling investment in total. At some point that is likely and it will need to pick up.

Ms JACKSON—So, in the current climate and with scarce resources, it might be suggested that, where we have large-scale investment, infrastructure investment, perhaps some sort of priority system should be given to that?
**Mr Stevens**—We are probably finding that not everybody can do what they want all at the same time; that would seem to be a fact. What device one might use to ration out available resources I think could be a matter of debate. One could also say perhaps that, in most countries, when you have an investment boom, it is typically not usually possible to have a consumption boom at the same time. You could think about saving more. Consumer spending has been very strong, although I think it is now slowing down. Fortunately, of course, we are able to tap the savings of foreigners as well, so that eases the adjustment. However, I would not like to pontificate at great length about what process one uses to ration out the spending—other than, of course, interest rate rises—as part of the general attempts to contain all this. That is our response.

**Mr Turnbull**—Just on that question of infrastructure investment in large projects, you have usefully reminded us that, in the short term, invariably their construction adds to aggregate demand. So, if aggregate demand is an issue and you want to moderate it, it works in the other direction. But, in the long term, whether any investment in infrastructure, be it private or public, adds to productive capacity is really a question of whether it has a net benefit, isn’t it? An infrastructure investment that is a white elephant is not going to add to productive capacity.

**Mr Stevens**—It adds to physical productive capacity. Whether it is financially viable—which is what you are going to—is a separate question, which is a matter for its proponents, public or private, to assess.

**Mr Turnbull**—But, in terms of prioritising infrastructure, isn’t the key allowing the market to set prices and having the microeconomic settings that allow prices for the services provided by infrastructure, be it water, energy or whatever, to be properly priced in the market? Market forces will then determine the projects that have the greatest net benefit and the greatest priority will be given to those projects.

**Mr Stevens**—I think that is probably right for many types of these investment projects. There are probably some types of public infrastructure where things beyond just the pure price mechanism may come in; I would add that caveat. I do not want to get into the politics of water and so on, but I think pricing actually does matter in getting the right outcomes in most of these areas. If I interpret you correctly, you are suggesting that market pricing, interest rates and all those sorts of things that financial markets also provide are the economy’s natural way of deciding priorities. I do not think that means there can never be any public intervention to have another priority, but that is certainly a very important mechanism.

**Chair**—Sharryn has one more question and then the way we will proceed with the last half hour will be to go back in the order we did before. It will be one question each, given the time that we have.

**Ms Jackson**—On a completely different subject, you have got some greater transparency requirements now, including the publishing of minutes and the like. I would be interested in the bank’s view on whether that has assisted with communicating your actions better, or whether it is still too early in the process, perhaps, to have a view about that.

**Mr Stevens**—You are right. We have made some fairly substantial changes to communication arrangements. There has been a longstanding discussion and this committee has in the past talked about some of these things. It is fair to say that the bank has shifted its position in recent
times. There are a couple of reasons for that: one is that, for a long time when interest rates were not changing much, we tended to feel that the obligation to explain why you are not moving them means that there is a potential thing that can go wrong, which is that everybody understands what is happening—you are not moving; they understand why—but every time you open your mouth there is a possibility that you will inadvertently upset the applecart. So there was an argument that you keep your mouth shut when you have nothing to say. We found that, for quite a long time, to be persuasive.

But also in recent times I have come to feel that there are plenty of times when you do nothing but you want to explain why very carefully. I think we have had more of those occasions of late than we used to. In my personal view, that is the thing that swung the balance from the view that I used to hold, and the bank held, and the one we have now.

With regard to minutes, we have a different sort of board so the minutes have to be written carefully. We do not have the kind of board that they have in the UK, which is often held up as the model, where it is explicit that you are appointed to be individually accountable and you know when you sign up for the job that your vote is going to be published. With that body, basically, they all talk, then they decide what they individually think, then they vote and that determines the outcome.

Other boards, of which ours is one, work harder on trying to find a consensus. We do not necessarily always find a unanimous one, but I think it is fair to say that it is more of a consensus seeking body. Our members are not full-time central bankers. They come from the community. So, for various reasons, it is not appropriate to disclose the votes and you have to write up the minutes carefully. But it is possible to do. I think we have found a way of doing it and I felt there was no reason those minutes could not be released.

The other change we made was just in the timing of announcement. That is really better governance. It is not good governance to decide something at 12 o’clock today and not announce it until 9.30 tomorrow. There were historical reasons that that was done in the past, but they have long since gone. It is much better practice, having made a decision, to announce it ASAP. As soon as we can get the statement ready, we announce it.

How is it working? I think it is working fine. There have been one or two occasions in recent months where the minutes told people things that they might not otherwise have known. I think the time will come when the minutes will mostly be pretty ho-hum. We ought to get to that position. But there is no reason people cannot have a fuller understanding, month by month, of what we thought the issues were, what we thought about them and why we made the decision that we did.

So I think that was a step forward. The standard for central banks has moved on a bit since we made changes in the past. I think this brings us more into the mainstream position. I am comfortable, and I think the board is comfortable, with the changes that we have made.

CHAIR—We have spoken a fair bit about mortgage stress, and there has been a fair bit of to-ing and fro-ing in relation to that, but I want to ask you about rental stress. Anthony Richards, the head of the Economic Analysis Department, in his address this year to the Economic and Social Outlook Conference spoke about the increased rental stress that has occurred in the past
couple of decades. I am interested in your views on the connection between the increase in property prices and rental stress and the role that monetary policy plays in terms of the rental market as well.

Mr Stevens—If you look at those people who are paying more than 30 per cent of income in rent and associated housing costs in that bottom 40 per cent of the housing distribution, I think it is true that it has gone up of late and rents are rising quite quickly. This is actually an example of the very long, circuitous connection between asset prices and consumer prices. What we have observed is that asset values in the property market rose a lot in the period from about 1996 to around about the end of 2003. They have slowed down and fluctuated a bit since then, but that was a big rise. So the yields to the investor in rental property fell. That is what tends to happen, actually. When asset prices rise it is the same thing as saying their yield is falling. But those yields, from an investor point of view, became too low.

While the investors were enjoying capital gains—and there are various tax elements to how that is treated—I guess the flow of income yield did not matter that much. But once you cannot assume that capital gains will be strong indefinitely—and I do not think we can have an economy where everybody can always confidently expect rapid capital gains; that cannot be the world we live in—those yields matter. They were too low and either the price had to decline, which did happen to some extent in some areas, or the rents had to rise, and that is what we are seeing. But I think we need to get to a better equilibrium in the housing market where the yields to investors are sufficient to be worth their while, and that adjustment is taking place. Ideally—and this is not my field of expertise—I think the community would like to see an equilibrium where the marginal cost of adding to the cost of dwellings, be they for owner occupation or for rental, is sufficiently low that homeowners and renters can acquire housing services at a rate of return which is adequate for the renters and affordable for the people doing the renting. I think that continues to highlight the need to look at whether there are ways of lowering that marginal cost of adding to the stock, from the supply side. Monetary policy cannot change that at all. We have to take the supply side of the whole economy, including this area, as a given.

Mr PEARCE—Could you outline to the committee what warnings you have issued to the current government?

Mr Stevens—Warnings about what in particular?

Mr PEARCE—Have you issued any warnings to the current government?

Mr Stevens—I am not sure what we mean by ‘issuing warnings’. We meet with the Treasurer monthly, as has long been the tradition, and talk about the economy and the various risks it faces. I do not think that would qualify as: ‘Treasurer, I am warning that you’ve got to do this or that.’ Most of our conversations with governments over the years have not been of that sort of nature. They are an exchange of information and opinion about what is happening, what issues may be arising and how we are thinking about things.

Mr PEARCE—Did you issue any warnings to the previous government?

Mr Stevens—About?
Mr PEARCE—Well, did you issue any warnings to the previous government?

Mr Stevens—I cannot recall us writing a document saying, ‘We warn you of X,’ if that is what you mean. I take it this is a reference to statements about warnings on capacity, or something. I assume that those comments that have been made have been about published things that we have said on capacity. The bank’s views on capacity constraints and the issues that arise from that for the economy are all in the public domain. There are no secret—

Mr PEARCE—I appreciate that. Thank you.

Mr TURNOUR—Picking up on that, though: you do market surveys in terms of talking to business. Over what period of time have those capacity constraints been discussed with government?

Mr Stevens—As I said before, the question of constraints on capacity of one form or another has been a feature of our liaison feedback and the published analysis that we have done for several years.

Mr TURNBULL—Governor, getting back to labour markets, we know that in any market if you constrain the operation of decisions by market participants you will reduce economic activity—rent controls over time, for example, will reduce the provision of housing. We have seen that experience both here and elsewhere. Equally, if you make it expensive to terminate the employment of an individual then that acts as a disincentive to taking the risk of hiring an individual. We have seen a very strong growth in employment, particularly in the small business sector. If the previous—the old—unfair dismissal laws are reinstated for small business, what impact do you think that is likely to have on employment in that sector? Is it likely to promote more employment or make employers less willing to take the risk of hiring people?

Mr Stevens—The general proposition that things which act as a barrier to exit will also tend to act as a barrier to entry, I think is right. I am unable to really give a definitive answer as to particular proposals on unfair dismissal—I cannot really tell you how great an effect the previous changes had or how much effect the current set of proposals would be likely to have. I do not really think I can answer that question precisely. I can only agree with the general proposition that barriers to exit can easily become barriers to entry and great care is needed in this area.

Mr BRADBURY—In relation to the issue of government spending, I note that Treasury has recently released analysis suggesting that, under the previous government, spending was increasing at a rate greater than at any time in the last 30 years. Given we have been in a cycle of monetary policy tightening now for 12 consecutive movements, has the fact that fiscal policy has been operating in the other direction over that period made the Reserve Bank’s job more difficult?

Mr Stevens—As I said earlier, demand is demand; whether it is from the public or private sector it is all putting some pressure on the economy’s capacity. That is about all I can say about that. A lot of the spending is at state level as well, and you can understand why they feel the need to do it: there are various bits of infrastructure that have to be upgraded—transport, water, electricity et cetera. It has to be done. In an ideal world that would be done when the private
sector did not want to do all this at the same time. But we do not actually live in that world, so things have turned out as they are. There is not much more I can say about that.

My only other comment on fiscal policy as a general proposition is to repeat what I said recently in a speech. In an economy like ours, where we have no debt and the budget is continually in surplus, it seems to me there is an obvious structural case that can be made for lower taxes. At the same time, in the current environment an obvious cyclical case can be made for fiscal policy to be tighter than that just for the moment in order to take the pressure off demand in the economy. That has been the case over several years now. So you have a structural case to lower taxes and a cyclical case not to, or even to raise taxes if you are really serious. Where to strike the balance is not an easy judgement for any government to make. I think the problem with this whole discussion about fiscal policy is that people come at it with one of those two time horizons in mind and they sort of talk past each other. There are two time horizons and therefore two conclusions that can be reached, and they are both equally valid.

Mr KEENAN—I want to follow on from that question. I am interested in where the linkages are between fiscal policy and monetary policy. The government are talking about tightening expenditure. I think they are saving $15 million on airfares for public servants. I hope that will not affect the bank, of course. If the government were to reduce expenditure, what degree of tightening would be required to help you do your job and take some pressure off inflation?

Mr Stevens—I do not think it would be sensible for me to sit here and nominate some hurdle that the government has to get over to get some particular outcome on interest rates. I would make a general observation. Domestic demand growth was 5.7 per cent in the latest year. It needs to be considerably lower than that. We are talking quite big amounts here. It will take very major changes in fiscal policy to completely obviate the need for what we are doing. I do not think it is realistic to expect that it can be obviated completely, but every little bit helps. I will be happy to see any support from fiscal policy we can get, but I think we have to be realistic about how much any government will be able to do in the environment we face. When all is said and done, containing inflation is mainly the central bank’s job. To the extent other policies can help—and I think there is a bipartisan agreement on this—that is great, thank you; we will take that. But my observation recently in that speech was that, even with fiscal policy and other policies calibrated as well as you can possibly achieve, there is still a job for monetary policy to do.

Mr MARLES—My last question is about labour productivity. Is labour productivity an important aspiration of labour market regulation, in particular providing an environment where employees can fairly bargain for their terms and conditions of employment, including, dare I say, around the issue of employment security?

Mr Stevens—Productivity is actually the source of growth in living standards; there is not any other source. We certainly cannot manufacture jobs with interest rates—or, for that matter, government spending—sustainably. Ultimately, productivity is the source of growth in living standards. In the long run, if it is not everything, it is pretty close to it. Labour market arrangements will have a big bearing on productivity performance. They will not be the only thing because there is also capital productivity, which is strongly related to product market rules as well. But labour market regulations are very important. But they have two functions. There are multiple dimensions of the goals—fairness is a goal, I guess, of labour market arrangements.
Most countries have some degree of public intervention in labour market arrangements because of fairness considerations. It is not our role to tell you as the parliament where you strike that balance. That is your job to work out and to implement. That is handled in the political realm, not in our part of the world. We take whatever set of labour market arrangements and the structures that they generate as a given and we work on demand. That is actually in your terrain.

Mr DUTTON—I wanted to ask a question following on from your obvious enthusiasm earlier about more open and transparent processes and the way in which you have enjoyed yourself today. I wonder whether you would be open to a suggestion or to an offer to come before this committee on a more regular basis. I note that Chairman Bernanke had been before the congress seven times last year. Is there a case do you think to be made, and would you be of a mind to accept an invitation to come here after each decision?

Mr Stevens—After each policy decision?

Mr DUTTON—Each monetary policy decision, yes.

CHAIR—This is a question not a request at this stage.

Mr Stevens—Once a month?

Mr DUTTON—Once a quarter.

Mr Stevens—I have been to almost all of these hearings since they started in this form in 1997. I think I have missed two. I think they have worked well. It seems to me, generally speaking, the frequency is about right. I think we would probably find that for large stretches of time there would not be enough new to say to come quarterly. It is really in the hands of the committee how often you want me to come. Perhaps there will be occasions where more frequent hearings might be useful, and the committee has on occasions held hearings on other issues too, so really we have to respond to what you want to do, and of course we will.

Ms JACKSON—I noticed in your annual report your references—in your reporting obligations in equal employment opportunity—to new software to assist staff with disabilities. I also noticed there is one woman on the Reserve Bank board. I did notice some senior women in the bank, but as someone who sits here with a lack of diversity in our own committee I wondered whether the bank itself is proactively pursuing greater diversity.

Mr Stevens—There is a diversity report that is done. We actually have a pretty diverse staff, I would say. We certainly recruit a lot of extremely capable young women. It is hard to keep them. We have done things with child care—the bank supports that, to try to make that easier. That still has not been quite as successful as we hoped. Interestingly enough it is used by more men than women. There is nothing wrong with men using it, of course. These remain issues for us, but all I can tell you is that, in my view, talent, however it looks or wherever it comes from, gets rewarded as soon as we possibly can. That is the best way to provide all these people from different backgrounds and of different sexes with the opportunity to spread their wings as wide as they can.
CHAIR—we have one more question, from Caringbah High School. Caroline Nguyen has a question for you.

Caroline Nguyen—as an aspiring RBA board member, given that, after 17 years of Australian GDP growth, the RBA is concerned about future inflation, despite major slowdowns in major economies such as the US, I would like to know how much longer this growth is sustainable and when Australia should face the possibility of a recession.

Mr Stevens—that is a good question but a risky one. I think the answer is that one of the prerequisites for sustaining the growth is to make sure we contain this inflation problem that we have. We will not be able to sustain the growth if we do not do that, but I think we will be able to and if that turns out to be right then we can sustain growth further into the future. I do not think we are going to have a recession anytime soon, and probably that is enough said on that matter!

CHAIR—on behalf of the committee, I thank you for your time today.

Resolved (on motion by Mr Turnour):

That this committee authorises publication, including publication on the parliamentary database, of the transcript of the evidence given before it at public hearing this day.

Committee adjourned at 12.02 pm