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

Members in attendance: Mr Bradbury, Mr Ciobo, Mr Dutton, Mr Keenan, Mr Marles, Ms Owens, Mr Pearce and Mr Craig Thomson

Terms of reference for the inquiry:
To inquire into and report on:
Reserve Bank of Australia annual report 2007
WITNESSES

BROADBENT, Mr John Stanley, Head, Domestic Markets, Reserve Bank of Australia

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

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

STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia
Committee met at 8.59 am

BROADBENT, Mr John Stanley, Head, Domestic Markets, Reserve Bank of Australia

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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 Loreto Mandeville Hall, Scotch College, Camberwell Grammar School, Xavier College and Balwyn High School. Following the rate reduction announced last week, the committee will examine the Reserve Bank of Australia’s inflation forecasts and the short- to medium-term outlook for monetary policy. Currently the committee is conducting an inquiry into the competitiveness of the banking and non-banking sectors. The committee will seek the governor’s views about the current state of the global credit squeeze and the cost of funding to lending institutions. There has been some concern in the community that the Reserve Bank may have gone too far in raising rates, resulting in a sharper downturn in the economy than was necessary. The committee will scrutinise the RBA about its conduct of monetary policy and what impact the slowdown is having on the economy.

Once again, on behalf of the committee I welcome the governor and other senior officials of the Reserve Bank of Australia 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 for the opportunity to meet here again in Melbourne with the committee. I thought it might be helpful for our discussion if I begin by reviewing how things stood when we last met in April, what has happened in between and where we stand as of today. When the committee met in April, monetary policy had been tightened in response to very strong growth in demand and a significant pick-up in inflation during 2007. The cash rate had been lifted by 100 basis points and financial intermediaries were facing additional increases in the cost of their funds, which they passed on to borrowers. This amounted, as we said at the time, to a significant tightening in financial conditions. That was necessary under the circumstances: if inflation was to decline over time to be consistent with the two to three per cent target, a precondition was to contain demand, which had run too far ahead relative to productive capacity. The fact that inflation picked up noticeably right at the end of 2007, with a likelihood that we were in for several quarters of faster price rises, only reinforced the need for a credible and prompt response by monetary policy.

In April, there was considerable uncertainty surrounding the outlook given the powerful forces at work pulling in opposite directions. On the one hand, the tightening financial conditions, including some tightening of credit standards for more risky borrowers, was acting to dampen
spending. In addition, developments in the global credit system were a likely dampener for the international and domestic outlooks. On the other hand, the rise in Australia’s terms of trade that was in train was the biggest such event for many years. It was starting to deliver a very large further boost to income and, potentially, to spending.

So, while there were signs in April that a slowing in demand had begun, it was unclear what the extent and duration of that slowing would be. Overall, the judgement we had reached at that time, and subsequently spelt out in the May Statement on monetary policy, was that growth in demand and GDP during 2008 would turn out to be considerably lower than had been recorded for 2007. This forecast was at the lower end of the range of private sector forecasts made at that time. That in turn led us to believe that pressure would be taken of productive capacity and that inflation would, in time, abate. It was on that basis that the board held the cash rate steady for six months, even though inflation on both a headline and underlying basis continued to increase in the subsequent two CPI releases.

The picture of moderating demand, at least on the part of households, has continued to emerge. Consumption spending grew modestly in the March quarter and then paused in the June quarter. This came after a very strong run-up in the second half of 2007, when consumption had grown at an annualised pace of almost five per cent, well above what was sustainable. Household demand for credit has slowed and turnover in the market for existing homes and house prices has softened, though spending on the construction of new homes and renovations has thus far continued to rise modestly. Overall, households are at present much more cautious about spending and borrowing after a number of years in which confidence levels were very high and there had been strong rates of growth in borrowing and spending.

Clearly, tight financial conditions have played an important role in slowing household demand. An additional factor around the middle of the year was a surge in global oil prices. Of course, oil prices had risen a lot over several years—from about US$30 a barrel in 2003 to reach around US$100 a barrel early this year. This was a large increase, but it took place over a fairly long period and against a backdrop of strong global growth, and most economies had taken that more or less in their stride. But the surge from nearly US$100 to nearly US$150 per barrel over a matter of weeks was a very sharp increase from an already quite high level. Accompanied as it was by forecasts in some quarters that the price could rise much further, this affected both purchasing power and sentiment among households in many countries, including Australia. It also made business conditions more difficult for many firms, and this, together with the effects of the increases in other costs, slowing household demand and tighter credit conditions, has been reflected in the various business surveys over recent months.

While all of that was happening, confidence in international credit markets has continued to wax and wane. Following the takeover of Bear Stearns by JPMorgan Chase in mid-March, sentiment improved for some weeks. Many people at that time thought that that meant the worst was past, but that improvement, unfortunately, did not last. Concerns about major international financial institutions re-emerged, as asset write-downs and losses related to the problems in structured products based on mortgages continued. A significant tightening of credit standards has ensued in some major countries due to the need for banks to conserve their own suddenly scarce capital resources. The soundness of the two large quasi-public US mortgage agencies, which carry actually very little capital, also came into question. That has necessitated support in a major way from the US government, as we have seen announced overnight.
Meanwhile, the US has seen house prices fall and house construction is at its lowest for many years. The US economy continued to expand in the first half of 2008 due to solid business investment spending, the impact of the fiscal stimulus and strong export performance helped by the lower US dollar. In fact, the US was the strongest performing G7 economy in the June quarter, with other major developed countries showing a significant weakening. But most forecasters continue to be pretty cautious about prospects for the US economy in the second half of the year and are now also concerned about the sorts of credit losses that are routinely associated with a period of weak macroeconomic conditions.

Some fairly significant changes of a financial nature are also occurring in Australia. Share prices rose in April and May, but gave all that back in subsequent months and at present are down by about 30 per cent or so since the peak in late 2007. Corporate boards are, I think, taking a more cautious attitude to debt, and there has been a marked reduction in business credit growth. That seems to have been more pronounced in the case of loans to large companies, though growth in credit to smaller enterprises has also slowed. Entities with complex financial structures and/or high leverage have come under pressure and are looking to de-leverage their balance sheets.

But, overall, what we see in Australia is an order of magnitude less troubling than what we see abroad. That, I think, is an important point to emphasise. The balance sheets of the bulk of corporate Australia are not overgeared. Australian financial institutions continue to present a contrasting picture to their peers in the US, Europe and the UK. They have adequate access to offshore funding, albeit at higher prices than a year ago. They have tightened credit standards for some borrowers, particularly those associated with property development and some other high-risk areas, and are holding a higher proportion of their balance sheets in liquid form. Some have had to make provisions for unwise exposures that had been accumulated earlier. But even in those cases, capital, asset quality and profitability remain very sound. The money market is functioning more smoothly than it was six months ago, with short-term interbank spreads relative to official rates down a little bit. There are also signs that the securitisation market, which effectively closed late last year, is moving closer to reopening. In summary, the Australian financial system is weathering the storm well.

Furthermore, while growth in credit to business has slowed quite sharply, and surveys say that business conditions have softened to the weaker side of average, overall profitability remains pretty strong. Businesses still are maintaining high levels of fixed investment spending. Indeed, according to the most recent data, released about 10 days ago, firms plan a significant further expansion of investment spending in the year ahead, at a pace as fast as anything seen in a generation. Strength in mining is exceptional, but other areas actually look robust as well. I have spoken in the past about the rise in the terms of trade adding to income and spending power. These actual and intended investments are evidence of that effect. Whether all of the planned investment will come to pass—or whether it is economically feasible for it to come to pass—is a question open to debate. Nonetheless, the strength of those intentions at this stage—a year into the global credit problems and many months into the more conservative financial environment in Australia—is remarkable. In addition, state governments continue to look to needed infrastructure upgrades. So these areas, on the best available recent evidence, remain likely to be sources of demand growth in the Australian economy in the period ahead.
This highlights again a theme that I have noted before—namely, the contrast between household demand and other types of spending. Even with a pretty significant slowing in household spending, total domestic demand in the economy rose at an annualised pace of about four per cent in the first half of 2008. That was down from about 5½ per cent last year but is still quite strong. This same picture has been pretty consistent from the liaison the bank does with its fairly extensive list of contacts around the country, numbering about 1,500 firms and other organisations. Those exposed to household spending are finding conditions subdued, while those exposed to the infrastructure and mining build-up are often struggling to keep pace.

Some of that demand has, of course, been supplied from abroad. So, at the bottom line, we come to production and capacity utilisation in Australia. At this time of the year, with two quarters of national accounts data available, growth in the economy is running at a pace slower than last year and slower than trend. Growth in real GDP, as we saw last week, slowed in the June quarter, though that was affected by a large decline in farm production that most forecasters expect to be reversed in the coming quarters. Abstracting from those swings, non-farm product rose by 0.5 per cent in the quarter, down a little from the 0.7 per cent in the preceding few quarters. There was nothing in those figures per se to cause us to revise significantly the forecasts we published about a month ago in the August Statement on monetary policy.

The international context is one of more subdued global growth than expected six months ago. The world economy actually expanded a little faster than we had expected into the early part of 2008, but recent data for a number of countries have been weaker and we are assuming that weakish performance will probably continue in the near term. Growth in China has slowed a little but still looks strong. Some of our other Asian trading partners, though, are facing more difficult circumstances now.

Turning to the outlook for inflation, with pressures going through the system as a result of the rise in raw materials prices and strong demand over the past couple of years, headline inflation figures will remain uncomfortably high for a little while yet. It is expected that annual CPI inflation will reach a peak in the September quarter of about five per cent and be similar in the December quarter. That is higher than was expected six months ago. But, with international oil prices below their mid-year peaks and with signs that the pace of food price increases are abating, it is reasonable to expect that CPI inflation will thereafter start to fall back. With demand growth slower, capacity utilisation, while still high, is tending to decline. Trends such as this usually dampen underlying price pressures over time, and those effects should start to become apparent during 2009 and continue into 2010.

This assessment hinges to no small extent on growth in overall labour costs not picking up further. Relative wages have been shifting over recent times, as would be expected given the nature of the forces that are affecting the economy, but overall the pace of growth in labour costs to date has been fairly contained, considering how tight the labour market has been. With pressure coming off the labour market in the period ahead, we think, an assumption that that moderate behaviour will continue appears to be a reasonable one at this point, but it is a critical one. The outlook also hinges on the expectation that demand growth will remain quite moderate in the near term so that pressure continues to come off productive capacity. On that basis, we believe that prospects for inflation gradually returning to the two to three per cent target over the next couple of years are improving.
An outlook like that is, of course, what the board has been seeking to achieve with monetary policy. As that picture has gradually emerged over the past few months, the question has then arisen as to when the stance of monetary policy should be recalibrated as well. At its August meeting, the board believed, and stated, that conditions were evolving in a way that was increasing the scope to move towards a less restrictive setting—that is, one that presses less firmly on the brake. At the September meeting, as you know, the board took a step in that direction. The logic of that decision was the same as the one that, some years earlier, had led the board to begin raising rates from unusually low levels: the setting of policy designed to get the economy to change course probably will not be the right one once the change of course has occurred, and it will need to be adjusted. A further consideration was that conditions recently had actually tightened marginally as the result of rises in lenders’ interest rates, which, from a macroeconomic point of view, was not needed.

Accordingly, the cash rate was reduced by 25 basis points last week. The decision had been quite widely anticipated and, in fact, less restrictive conditions in the money market had already been in place for about a month before the board took that decision. Since the end of July, key benchmark interest rates have fallen quite noticeably. The rate on 90-day bank bills has fallen by nearly 60 basis points, while the three-year swap rate—another key benchmark—has fallen by about 80 basis points. Various rates for fixed-rate loans had already declined before the board’s decision, while variable mortgage rates have quickly reflected the decline in the cash rate. The exchange rate has also declined. Some of that change is really a US-dollar story more than an Australian-dollar one; nonetheless, our currency has declined somewhat against other currencies and on a trade-weighted basis.

Admittedly, we are probably six months away from seeing clear evidence that inflation has begun to fall, and even then it has to fall quite some distance before it is back to rates consistent with the two to three per cent on average that we want to achieve. A somewhat larger fall in inflation overall is required on this occasion than was the case in either 2001 or 1995, which were the comparable previous episodes, since this time the peak inflation rate we have reached is higher. Rather than trying to achieve that larger fall by pushing inflation down more quickly, the board’s strategy is to seek a gradual fall but over a longer period. This carries less risk of a sharp slump in economic activity, though it does require a longer period of restraint on demand. On the other hand, it carries the risk that a long period of high inflation could lead to expectations of inflation rising to the point where it becomes more difficult and more costly to reduce it.

Monetary policy has to balance those risks, which is why the flexible, medium-term inflation-targeting system that we have been operating for 15 years now—and which has enjoyed strong bipartisan support in the parliament—is so important. That framework will continue to guide the board’s decision making. I will finish there, Mr Chairman, and my colleagues and I will be happy to respond to your questions. Thank you.

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

I will kick off with some questions. We have seen in 2008 interest rates go up twice earlier in the year and we have just seen a movement back down. There is a view being put in the community that the two movements in rate rises at the start of the year were perhaps
unnecessary. How do you respond to those sorts of questions in terms of what we have seen this year with the movement of rates?

Mr Stevens—I do not think they were unnecessary. I think they had to be done. If you think back to the information that was coming in at that time and that has continued to come in, particularly on inflation, I think the likelihood that we were going to be able to credibly sit through one bad CPI, then another and then a third—and there is actually a fourth coming that will not look too good—and not respond at all was pretty unlikely. When inflation is rising like that you have to respond. The earlier you respond the sooner you can get to a position where you can sit and say, as we did, ‘That’s tight. That will do the job. It will take time but it will work.’ I do not think we would have been in that position without those two changes at the beginning of the year. In fact, I think we could well have found ourselves much later in the year agonising over whether we should be raising rates even then rather than being in the position that we were in—being steady and then starting to think about coming down a bit.

I do not think either, by the way, that the fact that you start to go back down is really in any way a signal that the preceding changes were wrong. It is a signal that they did what needed to be done. They had the necessary effect. Once that effect is in place then you do not need that setting any more and you can ease up a bit, which is of course what we have done. So I think those moves did need to be done, but, if things worked out well, that setting of policy was only ever going to need to be in place for, hopefully, a relatively short time. That six months has turned out to be about the period and that is actually pretty similar to the last time we were at the peak.

CHAIR—So you are confident that those two interest rate rises are not going to lead to a hard landing and that we are still looking at a soft landing in terms of where we are at?

Mr Stevens—As I said in my remarks a few minutes ago, we have half of the year in and on the data to date we have an economy that in the non-farm economy, abstracting from the swings due to drought in the farm sector, has slowed to an annualised pace of about two per cent, by the look of it in the June quarter. Our feeling is still that the low point of growth will be lower than that, but I do not think those data would lead us to revise down any forecasts. Indeed, if anything, taken literally they suggest the economy is running a little bit quicker in the first half of the year than we had previously assumed. There is not a lot in that, and I am not about to rush to revise up the forecasts. But at this point I do not think there is anything there that says that things have evolved in an untoward fashion thus far. But it is a very uncertain world of course, and that is why we have to keep monitoring this every month.

CHAIR—Those with mortgages, in mortgage land right around Australia, obviously welcomed the most recent cut in interest rates, but the question that is on all of their lips is: what is your expectation for interest rates in the immediate or short-term future and are we likely to see another reduction before the end of the year?

Mr Stevens—If scope—to use that word—continues to increase, I am sure we will react accordingly, but I cannot come here and precommit or make a forecast about what the board is going to do at forthcoming meetings. The financial markets have priced in some further reductions in the cash rate over time. I do not have any particular agenda today to either dissuade...
them from that or encourage them any further. I think the step we have taken was the right one. We will assess the situation month by month.

**CHAIR**—You understand, of course, that mortgage holders out there are keenly looking at any relief that they can get in relation to this. Obviously today is an important part of trying to look at what might be happening in the near future. Can you say whether you think that we are in a period when we are looking more at a reduction than at a rise, or are you not prepared to say anything further in terms of that?

**Mr Stevens**—As I see it at the present time, we have moved from a phase where the question was ‘Have you done enough to make sure inflation will come down over time?’ to one where in the near term the question will be ‘Do we hold here or do we go down a bit more?’ Unless something quite surprising happens, it seems to me unlikely that we will be reversing course and going up again in the near term.

**CHAIR**—Which then obviously begs the following question. A number of banks increased their rates above and beyond the movement in the cash rate earlier in the year. Do you see any justification, in the current economic climate, for that to continue, or should we be looking at banks to be putting back down those rates that they raised above and beyond the cash rate rise?

**Mr Stevens**—The question of bank funding costs is a complex one and in some ways a rather vexed one, I suppose. To be frank, I think it is unlikely that banks will volunteer reductions in loan rates independently of the Reserve Bank lowering the cash rate, because the quantum of additional market funding costs that went into the system earlier in the year mostly is still there. It has not gone away but it is just not getting worse now, on the whole. If your question is ‘Given that they raised rates independently of what we did, will they cut them independently?’ that is of course their call, but it does not strike me that that is all that likely anytime soon unless market conditions change a lot. But, that said, the actual funding costs that they are experiencing at the moment for the most part have come down, and they have been able to pass on, as we saw the other day, a reduction through to the loan rates.

The one area in which the story can be a bit different is in the long-term funding that is raised, because a lot of that is offshore and nothing the Reserve Bank does actually has any effect directly on those rates. I think what the banks would say is that, if you have got three- or five-year funding, every month a little bit of that is rolling off and it is being replaced by new three- or five-year funding. With the rate at which that is happening, the rollover funding is at a much higher rate than what it was taken on at, so that is still incrementally raising those costs month by month. That is happening, although, on the information I have, that sort of funding is 10 or 15 per cent of their total funding, so it is not the majority—and these effects are incremental and fairly small month by month—so that is actually still rising, but most of the other costs of funds that are keyed off short rates have come down over the past month.

**CHAIR**—Would another aspect to the banks not reducing their interest rates outside the cycle be a tightening in terms of the competitiveness in the banking sector, with the non-banks virtually disappearing with the collapse of securitisation?

**Mr Stevens**—It is true that there have been some securitisations over recent months but at a much, much reduced pace compared with what we had seen up until about a year ago. My sense
is that prospects for securitisation restarting are improving. Basically, for the securitisers to be able to make money, they have got to be able to raise funds in the market and lend them on at a rate that competes with the bank’s mortgage rates, and that gap has got to be wide enough for them to cover all their costs. Until recently, with the quite elevated bank bill rates and funding costs like those, that business basically was not profitable.

As those short-term market yields have come down, I think prospects are improving. They are probably not quite there yet for them to be highly profitable, but I think things are moving in the right direction there. Our feeling is that securitisation will at some point be, once again, a feature of the system—one piece of competition in the mortgage market particularly. It may not be at the pace that we saw, which was very rapid until the international turmoil began, but I do not think securitisation is dead forever. I think it will get going again.

CHAIR—Clearly securitisation played a role, though, in increasing the competition in the banking sector, where we saw bank margins reducing from four per cent to just under two per cent.

Mr Stevens—Yes, and most of that decline in margins is actually still here. A little bit has been reversed, but the bulk of that decline is still in place and I doubt it will go away.

CHAIR—What is your view of the steps that the Bank of England has taken in relation to setting up a special liquidity fund to swap illiquid assets for liquid assets for one to three years?

Mr Stevens—The UK, rather like the US, face a pretty serious situation with the problems that their banks have had raising funds and the amount of assets that they have got on their balance sheets, and the UK housing market is in a far more parlous situation than anything we see here. I think that, as in the case of the US, once you have got problems that serious you have got to have some pretty bold action to try to arrest the downward dynamic and stabilise things. But the public purse has taken on quite a risk there. I am not saying it was the wrong thing to do. I think it is the sort of thing you have to do in an emergency, so it is probably correct, but I do not think anything we face here is remotely that serious.

CHAIR—Would the better use of RBA repurchase agreements help bring liquidity back into the market?

Mr Stevens—As you know, last year we widened the pool of eligible collateral to include RMBS. We are willing to take RMBS on any day that someone wants to come and repo it to us. I would have to say that, by and large, not many people want to bring it. In fact, some months ago we took a slightly unusual step of saying: ‘We would like to have some RMBS for a year, please. What about it?’ Some came in, but it was almost as though people needed a bit of encouragement to do that. I think our arrangements there are basically on par with what other central banks do. I think the widening we did was appropriate to just lend a bit of confidence to markets generally. We have $2 billion or $3 billion on repo right at the moment out of a total repo book that is $50-odd billion. I suppose what I think is worth noting is that not that many market participants so far have been all that keen to bring us this stuff. They are usually keener to bring us bank bills and other bank paper.
The other thing, I guess, to say is that those arrangements are about short-term liquidity management. But, in the end, banks and other lenders have to find their long-term funding in the market. It is not our job to provide a substitute for longer term market funding unless you are really in an emergency. In an emergency, that would be different, but we do not face that. I think the repo arrangements are working quite well. They are as liberal as those any other central bank has in its normal operations. I think we are pretty content with that at the moment.

CHAIR—I have a question in relation to your comments about limited spare capacity and growth demand. We saw interest rates go up five times in 2006 and 2007. Were those rises primarily based around concerns about inflation and the capacity constraints in the economy? What would have occurred if the Reserve Bank had ignored those concerns?

Mr Stevens—What would have happened is what would normally happen if you have an economy where demand is growing strongly with evidence of capacity constraints, which was quite a prominent feature of the business liaison we were doing, as well as, I think, being evident in data. The inflation that is presently still too high would be higher, and we would be facing a bigger problem. We would end up having to put interest rates up a fair bit more than we have. That is why, when you see evidence of that, you should respond as early as you can reasonably work out the problem.

CHAIR—So if we had ignored inflation we would be in a situation with higher interest rates now, or the Reserve Bank would be looking at higher interest rates?

Mr Stevens—There is no doubt that, if you let inflation get higher and get stuck there, you will end up with higher nominal interest rates. It is one of the clearest empirical facts in economics, and everyone knows this, that high-inflation countries are the ones that have high interest rates. Since we have been a low-inflation country—since about 1992—we have had, on average, much lower interest rates than we had in the 15 years or so before that. I think we all agree that that is the world we would like to stay in. There is a bit of work that is needed to be done to make sure we do.

Mr PEARCE—Governor, firstly, welcome to Melbourne.

Mr Stevens—Thank you.

Mr PEARCE—It is nice to see you and your officers in Melbourne this morning.

Mr Stevens—The weather is much better here than it was in Sydney on the weekend, I can tell you.

Mr PEARCE—That is often the case. Let me start by asking you a broad question. How do you think working families in Australia are going?

Mr Stevens—I think it has been tough for many of them, particularly those who are indebted; yes, that is right.
Mr PEARCE—As you know, we get advice and briefings from various groups of people. The committee has been advised that there is a high risk that Australia might enter into a recession. What do you think of that?

Mr Stevens—I do not think we are in recession now. I do not think there is the evidence to suggest that. We are in a period of slow growth, rather like two or three episodes of that nature that I can recall over the years. I think it would be dishonest to deny that there is any possibility at all that we could have a recession. There is clearly some probability of that, but I think the most likely outcome continues to be the one that is in the outlook that we have put out over the last six months publicly.

As I said earlier, on the data we have so far I would not say things are weaker than that outlook. The composition of things is different. Household consumption is probably a little weaker, investment is a little stronger and probably public spending is a little stronger than we had assumed some months back. But GDP growth, as I said before, right at the last data we have is, if anything, slightly higher, though I think we will still get to about the same low point in growth. It will maybe take a quarter or two longer to get there. So is there a zero risk of recession? No, it is not zero, but I think the most likely outcome is the one that we are talking about in our published outlook.

Mr PEARCE—Governor, I want to draw your attention to the evidence you gave the committee when we last met in Sydney in April. At that hearing in April I asked you whether you had issued any warnings to the previous government and you replied—I quote from Hansard:

I cannot recall us writing a document saying, ‘We warn you of X,’ if that is what you mean.

I take it you stand by that evidence given in April?

Mr Stevens—Yes.

Mr PEARCE—Let me read you an excerpt from Hansard of just last Monday, when Prime Minister Rudd responded to a question in the House on the economy. He said this:

But that economics 101 was the subject of 20 separate warnings to those opposite through the Reserve Bank, each of which they comprehensively ignored. The impact over time of ignoring each of those warnings, year in, year out, is that spread over many years those inflationary pressures build, and that is precisely what has occurred. It is not just on infrastructure, but it is also on skills. I read through these warnings from the Reserve Bank again this morning; they make for quite stark reading.

So, Governor, I have to say I am a bit confused. You said in April that you did not issue any warnings, yet the Prime Minister read through 20 separate warnings last Monday, according to Hansard, that you issued to the previous government. I want to assume that the Prime Minister is not misleading the House, and on that assumption the 20 warnings must exist. So can you give the committee a copy of the 20 separate warnings?

Mr Stevens—I do not think I can furnish you with a document entitled ‘Warning on capacity utilisation’ or capacity constraints. So no, I cannot furnish you with a document. The only thing I
can furnish you with is what we have already furnished the Australian community with, which is our published statements.

**Mr PEARCE**—They are on the public record.

**Mr Stevens**—They are on the public record and they have been all along.

**Mr PEARCE**—I want to talk to you about the unemployment rate. It is around 4.3 per cent presently. Given that you and your team are aiming to achieve long-term, sustainable inflation within that target band of two to three per cent that we hear a lot of, what do you think is going to happen to unemployment over the next 12-month to two-year period? What are you projecting the rate of unemployment to get to?

**Mr Stevens**—In an episode of this type, which we have seen before, I think—and we have said this publicly—the rate of employment growth will slow. It is starting to do that already in the data we have over the past two or three months. Vacancies remain high, but they have started to decline off those highs, as best we can tell. So that is a picture consistent with a period in which the economy is going to grow below average for a while. We have seen that before, in the early part of this decade, in the middle of last decade and some other episodes if you go further back.

In an ideal world, when you tighten up on demand for a while that flows immediately, or very quickly, through to wages and prices slowing down, and there is not much change at all in unemployment. In the real world, what we have tended to observe in these episodes is that the unemployment rate goes up for a while—it does not skyrocket, but it goes up for a little while—while inflation is brought back under control, and then it can stabilise and possibly even go down again. That was the story, for example, in 2001. We had a period of slow growth. That contained inflation. The unemployment rate rose for a while, and then it started to come down again and kept going down subsequently. So, in general outline, it is not that there has to be some rise in unemployment to achieve what we are trying to achieve but, in the real world, in other episodes, that has been what tended to occur and I think we have been honest enough to say that on this occasion. So it is going to rise a bit over the next year to 18 months, I would say.

**Mr PEARCE**—What do you mean by ‘a bit’?

**Mr Stevens**—Well, I think, in many respects, we could see what is going on at the moment as rather akin to the mid-cycle pause in 2001. In that episode the rate of unemployment rose by a percentage point over a year to 18 months. I am not setting that up as a precise forecast but, qualitatively, that sort of episode I think is probably what we are experiencing now.

**Mr PEARCE**—Governor, I want to talk to you briefly about the interest rate increase at the beginning of this year. You obviously had your set of projections, and we have heard your statement this morning, and you looked at the domestic dynamic in Australia and the international trends as you saw them. But, with the benefit of hindsight, do you think that the board got it wrong earlier in the year, and do you think that you underestimated some of the international consequences flowing out of the subprime crisis and some of the other things that you have mentioned in your statement this morning?
Mr Stevens—No, I do not think the board got it wrong. As with my answer to the chairman’s question at the beginning, I doubt very much that we could credibly have just sat there with inflation doing what it was doing; I think you have to respond to that. The international situation is still very fluid and very difficult to predict. If anything, though, early in the year, I think global growth turned out higher than we thought. For probably a couple of months after the March move in interest rates here, conditions abroad were looking better.

I think that, on the information we had then, on the assessment of the risks that we could make then, and even looking back, those moves were correct. Really, the question we ought to be asking here is: where do we want to be in two or three years time? I think where we want to be in three years time is: an inflation rate back down to those two-point-something numbers, the interest rate that goes with that also in place by then, and conditions conducive to a continuation of steady expansion in the economy at a sustainable pace. That is where we want to be. And I think those movements, plus the one we have just done in the other direction, will turn out to be the right thing to get us towards that point, based on what we know now.

Mr BRADBURY—Governor, I would like to ask you to reflect on some of the comments in your opening statement on page 5. Regarding the second paragraph, I am seeking greater clarity on what is meant by this statement:

At its August meeting the Board believed, and stated, that conditions were evolving in a way that was increasing the scope to move towards a less restrictive policy setting—one that presses less firmly on the brake. At the September meeting the Board took a step in that direction. The logic of this decision was the same as the one that, some years earlier, had led the Board to begin raising rates from unusually low levels:—

this is the bit I especially want greater clarity on—

the setting of policy designed to get the economy to change course probably will not be the right one once the change of course has occurred, and it will need to be adjusted.

Can you elaborate on what is meant by that statement?

Mr Stevens—If you think back to the things that we were saying some years back, when interest rates had reached unusually low levels for all of the reasons that were in place then, you do not keep those in place on and on and on because you will get into trouble one way or another. We said at the time that the inflation rate that starts to get things back on track is not the one that you keep in place once you are back on track. I hesitate to try to use analogies because they can at some point break down, but if you want to change lanes in your car you apply a bit of steering and once you are heading in the right direction you straighten up. In other words, the setting that got the direction change going is not the one you keep on; otherwise, you keep changing direction further and further. Obviously, if the economy is slowing, you do not have to keep pushing it down and down and down; once it is moving in a better direction, you recalibrate your setting to one more appropriate to the track that you are now on. That is what those words were trying to say. I think that is entirely consistent with the way we have behaved in the past at the other end of the cycle.
Mr BRADBURY—Correct me if I am misunderstanding what you are saying, but I interpret that to be that we do not need to wait for inflation to return to the target band before readjusting the settings.

Mr Stevens—Exactly. Just as you are not supposed to wait until it has already gone out of the band to start tightening—and we did not—you probably should not keep the peak setting on until the inflation rates come back down. I think to keep quite tight conditions for another two years sure will bring inflation down—it will be very smartly on its way a lot lower—and that is not what we are seeking to achieve. You do not wait for the target to be evidentially re-achieved before starting some adjustment, because I think that would mean that you would wait too long.

Mr BRADBURY—The statement continues:

A further consideration was that conditions recently had actually tightened marginally as a result of rises in lenders’ interest rates, which from a macroeconomic point of view was not needed.

If it is accepted that those out-of-cycle increases—if I can refer to them that way—were not needed from a macroeconomic perspective, and given your answer to the chair’s question a bit earlier, that it is unlikely that the banks would lower their rates outside of a rate reduction from the RBA, doesn’t that mean that there is justification for further cuts to restore the position pre the 55 or so basis points increase that has occurred as a result of the lenders increasing their interest rates from a non-macroeconomic policy perspective?

Mr Stevens—No. My comment that recent tightening was not necessary had in mind the 12 or 15 points rise in mortgage rates that occurred in July. It was not meant to imply that all of the other rises have to be reversed per se. Having said that, I do not mean to imply that we are not giving any thought to reducing the cash rate further. That will be the issue that is before the board at forthcoming meetings. But I am not in a position to say today what decision they will come to. The bit about them being unnecessary, I should be clear, was that during July mortgage rates rose a bit further and by that point of proceedings it was not our view that conditions needed to tighten further. We were coming to the view that we now needed to think at what point we would start to ease them. It is in that sense that I made those remarks in the opening statement.

Mr BRADBURY—I note that Ralph Norris, Chief Executive Officer of the CBA, has recently indicated that he is not prepared to rule out future increases in rates outside of the Reserve Bank’s movements in the official cash rate. I take it, from the answer that you gave the chairman a bit earlier, that from your perspective there does not appear to be any justification for the banks to head in that direction.

Mr Stevens—I am not in a position to offer comments on what Mr Norris said. Our position is simply that, across the parts of the market where funding costs are driven by short-term rates out to a year or so, those rates have come down of late and they are not increasing. As I said earlier on, there are some components of banks’ funding costs which, month by month incrementally, are still rising, because they are replacing the earlier long-term funding they got with new long-term funding. Even if those long-term funding rates have come down from a month or two back, they are still higher than the costs that they are replacing. So that is occurring; the question really is how big a dynamic that is in their overall funding costs. That will probably differ from bank to
bank. I think that at the moment their costs overall have come down and that is why they were able to reduce their loan rates—some of them just the other day, after our announcement, and some actually a bit earlier than that.

Mr BRADBURY—John Symond, from Aussie Home Loans, appeared before this committee in the course of its inquiry into competition in the banking sector. He made some comments in relation to a view that he holds that lenders should not in any way be tied to movements in the official cash rate. He suggests that a decoupling of the two would be the correct state of affairs, allowing lenders to charge rates that reflect the costs of their funds without responding in the way to which we have grown accustomed, at least over the last decade or so. What is your view in relation to those views, and what would be the implications in the longer term for monetary policy as an effective policy tool if such a decoupling were to occur?

Mr Stevens—The period that we had where mortgage rates and the cash rate moved in lockstep was a period when movements in the cash rate were actually a pretty good proxy for the vast bulk of short-term funding costs that banks—and not just banks but others—experienced. But if you go back into history earlier than just the past 10 years or so, it was not like that to anything like the same extent. There was less of a coupling—to use that word—in those days. The market conditions that we have seen in the past year have been such that that relationship has not been as close as it was for some years. I got into a fair bit of trouble at one point for pointing that out, but it is a fact. I do not know whether the way things turn out in the future will be the same or not.

There is not any law that says banks can only adjust interest rates when we do. It is just that most of the time in the past decade what the Reserve Bank has done has been a pretty close proxy for what all the other funding costs did, so the practice grew up the way that it did. But it is a market. We are controlling one interest rate—the overnight interest rate—and that has a lot of influence but not necessarily complete and total control over every other interest rate that is out there.

As for whether monetary policy gets less effective if the coupling, as you call it, is not as strong, yes, to some extent, but it strikes me as still pretty likely that movements in the cash rate will still have a fair amount of influence, even if not exactly one for one. You can compare the situation that we are in with that of the United States, where it is actually long-term rates that matter most for borrowers. The Fed has got the fed funds rate at a very low level, but in fact mortgage rates for borrowers have declined hardly at all, if at all, because they key off those five-year or 30-year Treasury yields plus a margin. So in that case the capacity of the central bank to affect a lot of the rates that borrowers actually pay is much less direct than we have, even now that, in our case, the cash rate and some loan rates are not exactly one for one necessarily every time but there is still quite a lot of influence there compared with what you see in some other countries. I think that will probably still be the case.

Mr BRADBURY—I have one final question. We have seen the US Treasury’s actions in relation to Fannie Mae and Freddie Mac. Do you have any views on what the implications of those actions might be, particularly in relation to whether or not that will have an impact on funding costs of banks within Australia?
Mr Stevens—I think what the American authorities have done—from the brief look at it that I managed to do this morning—is the right thing. I can probably get Phil to talk a little bit about what they have done, if you like. The implications, it strikes me, are likely to be positive for markets, at least in the near term, because it is a source of uncertainty that is closer to resolution. I do not really know what that will do to offshore funding costs for Australia’s banks. I cannot imagine that it will worsen the situation, though. On the whole, I think this is a step they had to take, but it is good that they have done it. Do you want to add anything, Phil?

Dr Lowe—I think the uncertainty about what was going to happen there has really hung over the markets over the last couple of months. Many people had been calling for the US authorities to make clear what they were planning to do, and so from that perspective I think what has happened is actually a very good outcome because it will help remove that uncertainty. The agencies are going to come under the management of the Federal Housing Finance Agency, the liquidity support facilities are being strengthened, there is an agreement that preference stock would be issued to the authorities if it was needed, and the Treasury will also buy some agency RMBS. I think together that helps reinforce the sense that this problem will be dealt with, and in the medium term I think that will be good for market confidence and ultimately the funding environment. There is still a lot of work to be done, but I think it is a good step.

Mr BRADBURY—But you do think it will lead to a reduction in funding costs?

Dr Lowe—The link is probably not particularly strong. What it will do is help remove some of the uncertainty that has been hanging over the market. If that persists, then one would expect that margins might come down a little bit.

Mr KEENAN—Governor, in your opening statement your evidence suggested that economic conditions in Australia, whilst challenging, are fundamentally better than in some of the other larger economies around the globe, yet confidence levels here have collapsed and are significantly lower than in those economies. Why do you think that is the case?

Mr Stevens—I am not sure that that is right, actually. I would not say that confidence levels generally have collapsed. Consumer confidence is low.

Mr KEENAN—All the significant surveys suggest it is the lowest since the early 1990s.

Mr Stevens—And, I think, given not just the rise in borrowing rates but also higher petrol prices, the stock market is off—so things like that have all been part of that. In the business community I would say confidence measures in surveys have come down—that is certainly true, and they are below average—as they have done several times in the past decade. At the same time, though, as I said at the beginning, there appears to be enough confidence at the moment for an enormous planned upgrade of investment spending. That survey was taken in July and August. That is plenty of time for pessimism to have started to influence those responses. I suspect that not all that investment will ultimately get done—and probably cannot get done, actually; there would be too much if it were. To me that does not, at this point, seem consistent with a collapse of confidence. Confidence has come down from very high levels to below average, but I do not think that is disastrous. It is similar to things we have seen several times before over the past 15 years in the course of the expansion.
Mr KEENAN—What I was specifically interested in was why confidence in Australia is relatively lower than in some of the other major economies.

Mr Stevens—I do not think it is. I do not think that is right, to be honest.

Mr KEENAN—Well, certainly in the United States and in the UK, which would be—

Mr Stevens—Europe, Japan—

Mr KEENAN—arguably facing worse situations than us, confidence levels are higher than they are in Australia. Their confidence in the management of the economies there are higher than they are in Australia, even though those economies seem to face more significant challenges than ours.

Mr Stevens—I am not sure what evidence you are appealing to for the idea that confidence in the management of the economy is higher there than here. There may be some evidence but I am not aware of what it is.

Mr KEENAN—It is just that, in the relative surveys, they seem to be more confident about the management of their economies and about the future of their economies.

Mr Stevens—Which survey are we taking about?

Mr KEENAN—I do not have the information in front of me but the OECD confidence levels were significantly higher than they were in Australia.

Mr CIOBO—To be of assistance to Mr Keenan, there are a number of surveys. The Sensis small business survey is the leading indicator that has shown a collapse of small and medium business confidence. The Nielsen survey, when comparing declining consumer and business confidence levels around the world, shows Australia’s confidence level has collapsed at twice the rate of other OECD countries. They are the two leading confidence indicators that I think Mr Keenan is referring to.

Mr Stevens—I have not got that evidence here but I think there are grounds for a fair bit more confidence in prospects in Australia than the US, the UK or most of mainland Europe. The economic evidence so far, in the data, would support that assessment, I think. The last consumer confidence in Australia that I am aware of actually showed a rise, although still off a fairly low level.

Mr KEENAN—Governor, it is actually the OECD that measures relative confidence amongst its member economies, and the collapse in Australia has been significantly worse than in any other OECD economy. I suppose my interest is why it is relatively worse in Australia when conditions here are, based on your evidence, significantly better.

Mr Stevens—I am not sure I can explain, Mr Keenan, why that particular survey would have shown that outcome. The confidence surveys that we track have come down from very high to below average. That is certainly true. I think that is what one would expect to occur in an environment where we have had a very strong period and now we are going to have a below-
average period for growth, as happens periodically; you cannot grow above average indefinitely. As for measures of business surveys that I am familiar with in Europe and the US, I would not say that they are stronger than ours. I cannot give you an explanation of the OECD findings. I have to admit I have not seen that particular survey.

Mr KEENAN—Okay, I will move on. I want to ask you a couple of questions about the ETS. Last time you gave evidence to us you compared the introduction of an emissions trading scheme and you suggested that it would have a similar effect to that of the introduction of a GST; that is, there would be some price movements up and some price movements down but essentially there would be a one-off spike in price movements and obviously that would be reflected in the CPI. But you suggested that if those price increases were to happen incrementally over time that would be a significant problem in terms of your challenge of managing inflation. We do have some further information about how the ETS is going to be structured; Professor Garnaut actually released this further information last week. He suggested that there would be an initial price impact of $20 per tonne in 2010 but it would rise each year by four per cent plus the percentage increase of the consumer price index. In light of that further information we have, do you think that the introduction of an ETS will make your job more challenging?

Mr Stevens—Actually the government is yet to decide exactly what they are going to do on the implementation of an emissions trading system. Until they come—

Mr KEENAN—This is if they were to adopt the draft report.

Mr Stevens—Well, I don’t know whether they will or not. With the $20 a tonne, if I remember the previous draft correctly, I think, Malcolm, the modelling—it is not our modelling but the modelling in that report—said that was 0.9 per cent on the CPI, was it?

Dr Edey—Yes, that is right.

Mr Stevens—There is an initial impact of 0.9. I think we will give an indication of how we will think about this once we are closer to something actually being decided and implemented, but at this point I would be inclined to think that we will probably regard that as a one-time thing like the GST was. As for the incremental ones each year, it really depends how big they are. If it is 0.9 every year, we have got a problem in the sense that I think it might be hard to convince people that this is not really inflation and that we will look through it if it happened every year for year after year after year. But most likely the incremental effects after the initial one will be pretty small. If they are quite small, then I doubt that they will present us with a great problem. If you are talking a tenth of a per cent or something, that I do not think is going to really seriously derail things from an inflation expectations point of view. So it depends how big it is, and you may end up with quite a high price of carbon in the long run but if it takes 50 years to get there then I do not think the incremental adjustments each year would be likely to seriously take inflation expectations off course, and that would be the test that I think we would want to apply. But beyond having any more details I cannot really give you a much better steer than that I think at the moment.

Mr KEENAN—What briefing has the bank received from either the Department of Climate Change or the Treasury on the proposed introduction of an ETS?
Mr Stevens—I have not received any briefing myself. We established a small group in Malcolm’s area some months back to keep an eye on climate change issues so that when the time comes for us to make an assessment we will be able to do so. I assume that they have some interaction with people in Canberra, but maybe I should get you to talk about that, Malcolm.

Dr Edey—Our people have informal contact with the people in Treasury and Climate Change that are doing this work.

CHAIR—Did you say ‘informal’ contact?

Dr Edey—Yes. We have a lot of regular contact with these people. Also, we are using the material that is on public record—the Garnaut report and so on.

Mr KEENAN—If we are going to have an initial introduction of a price for carbon which will increase over time then surely that is going to make your job of controlling inflation more difficult?

Mr Stevens—I think it really hinges on people understanding that, if you take the pure ability of me or you as a consumer to have command over energy resources at a price, if the price of carbon rises, our ability to command those resources diminishes. We could accept that and say, ‘I accept that that has to occur and that there is a bit of compensation as well,’ which is another factor in the mix here. I can accept that the little part of my living standard that is defined by my ability to purchase products that are carbon intensive goes down. I can accept that or I can seek to offset that by raising my price, which might be my wage or the price of my output if I am a business, to try and regain where I was. If we have that, then we have an inflation problem. If we have a situation where people say, ‘Yes, I understand what is happening and I have also got some compensation for that,’ so there are no second-round effects, then I think probably we will get through this without a serious problem for inflation and therefore for monetary policy.

So it will depend on how people respond, which I guess will hinge a lot on how good a job is done in explaining to them what is happening, what the compensation arrangements are and getting them to accept all that. That will be a task for the government, obviously. But it depends on how successful that is. I do not at the moment assume that we are going to have a serious problem for monetary policy here at all. I think if it is well handled we will be fine, the way we were with the GST. With that there was quite a big one-time rise in the CPI but within a year it was out of the inflation rate. We looked through that, the community looked through that, and we kept on about our lives without getting pushed seriously off track.

Mr KEENAN—I suppose the difference with the GST is that it was a one-off change in prices, whereas this is going to be a consistent increase in prices every year.

Mr Stevens—it depends on how big they are, though. That is my point.

Mr KEENAN—Just to clarify: you are saying that if business were to absorb all the extra costs it would not make your job of managing inflation more difficult.

Mr Stevens—No, that is not what I said, with respect. What I said was that if people accept a rise in the price level—which usually means a decline in your living standard—if we have all
accepted that that has to occur and there are no ongoing rounds of seeking to get that back over time, then you do not have a spiral and then we are okay. I was not suggesting that business absorb all the costs necessarily. Presumably consumers will bear the costs of these measures if and when they come in. Consumers ultimately bear costs in the economy.

Mr KEENAN—Okay. Thank you.

Ms OWENS—Thank you, Governor. We have had one question about confidence surveys. We do tend to hear some varying ones at various times, but I note that in your opening statement you said that according to the most recent data, from about 10 days ago, firms plan a significant further expansion of investment—in fact, the highest for a generation. I wonder whether you can talk a bit about confidence as it has flowed through the community over the last few years and where we stand now across the different sectors.

Mr Stevens—I really think the main thing is that the expansionary forces in the economy have been ones that affect the resource sector and other sectors that supply that sector—which would be construction and various other areas. That is a powerful expansionary dynamic. I know I have quoted these figures before, but with a rise in our terms of trade of two-thirds over five years there is a lot of income there, and there is a lot of potential future income that people see. So, in that sense, you would not be surprised to see a big run-up in mining investment occur, and it has occurred, and there is more on the slate according to that survey released the other day. It is not just in mining. The other sectors are also pretty solid. Mining is really strong, but the others are also pretty solid. So that is the positive.

The dampening forces have been higher interest rates. Higher cost of living itself is a kind of dampener for households, so the household sector is feeling squeezed. This is, as some commentators have pointed out recently, the two-speed economy, so to speak; households are subdued and businesses—and state governments also in their infrastructure efforts—are strong. That is probably the neatest single divide, I think, that one could point to in the economy. It is in that sense that, I think, confidence has diminished, and that is not surprising. Given what is happening abroad, what has happened in the share market and the fact that the economy is slowing, you would expect that. But, at least according to those capex data the other day—and these things get revised every three months—the surprise to me was that they were not revised down; they were revised up. So there is still quite a lot of intended investment, at least there was at that point—which was July-August—when they filled in this survey.

Ms OWENS—Talking about the squeezing on households, we have just had the first interest rate cut for seven years, so that squeezing of households has been going on for some time. At what point in the last few years have you started to see that have an effect on household confidence and household spending?

Mr Stevens—It is quite clear, I think, that really up to the end of last year household spending was growing very strongly, helped by income growth; there were high levels of confidence. Really it is this year, from about March on, that it has been much lower. I suspect that in the near term what is likely to happen is that tax cuts will come in. Interest rates have come down a bit; fuel prices have come off. That is probably easing the pressure to some extent.
Ms OWENS—This question has been asked before, but I get asked it a lot out in my community, so I am going to ask you too. Particularly with the two interest rate rises in February and March, which were very close together, a number of people in my area said to me, ‘The interest rate rise hasn’t even flowed through to my mortgage yet and now we have another one.’ One of the questions that my constituents were asking was: why was the next one, if you like, so close to the last one when the last one had not actually flowed through?

Mr Stevens—It is a reasonable question, but remember that if you go back in history it is not that uncommon for some to be quite close together or indeed only a month apart. There have been several episodes in that seven-year period you mentioned where that occurred, so that is not unusual. When we saw that inflation was rising more than we expected, to me it was fairly clear that that needed a pretty decisive near-term response, and the more decisive that was the sooner we would be at a point where we could then hold for some time. You could consider doing a larger move or you could consider doing two closer together.

I know that some people think that you should do something and then wait as long as it takes to see what the effect is, but you would wait years; in the interim, the economy is moving along. So, yes, you make a move and you are looking for the response to that and the previous moves, but your assessment of how much is needed is also shifting each month. Those two dynamics of course have to be combined. On occasion that leads to moves close together. Of course there have been occasions when moves close together going down also occurred.

Ms OWENS—Thank you. That is a slightly better answer than the one I have been giving, so that will help. I would like to talk about capacity constraints a little bit, which, again, has been raised before. I remember prior to the 2004 election that there was already talk about skill shortages and infrastructure shortages, and I note a Reserve Bank statement in March 2005 that referred to the possible risk of those constraints. I would love to ask you about the previous government but I know you would not answer, so I will ask it in another way. Given that we have such strong growth in the resources sector, what, for you, would growth look like without the froth of inflation? What is necessary not to bump up against those capacity constraints?

Mr Stevens—The resource sector has had capacity constraints because nobody predicted the extent to which demand from China and so on would pick up; no-one in the world predicted that. That is why the resource prices went so high—because there was not enough capacity anywhere. They have a lot of investment coming on stream at the moment and in the period ahead to respond to those capacity issues, and Malcolm could elaborate more if you wish. We will see a pick-up in resource export volumes.

In the rest of the economy we reached a point where we were more fully employed than at any time in a generation and where more and more businesses were saying to us, ‘Our biggest problem is we can’t get the people.’ Indicators of capacity utilisation from surveys were very high. They have come down a bit in the past six months or so but they are still actually quite high. That is an outcome you get when you have had a long upswing that has been a pretty good one overall.

The economy’s potential to supply probably rises at about three per cent a year, give or take a bit. If demand is rising at four, five or six, which in various years it has, sooner or later you are going to reach the point where you are stretching that supply capacity. That is what we were
saying—that we have to slow down, because it is increasingly the case that capacity has been reached. It does not mean that you cannot grow at all, but it means the period of strongly above-trend growth you have in the recovery from a recession has to slow. You want to grow above trend to use up the capacity, but once you have done that you have to slow down to something more in line with the economy’s medium-term growth of potential supply, and that probably has a three at the front at the most—three, 3¼ or something like that. You cannot have demand growth at five and expect that that will not give you a problem on inflation.

CHAIR—We are at 10.30. Governor, as you know, we also have some schools here today. We are just about to have a short adjournment, but before we do we might get two of the schools to ask you a question, if that is okay. Will from Scotch College has a question.

Will—In relation to inflation, does the RBA have a percentage figure as to the causes of inflation? For example, is it 60 per cent or is it 70 per cent? And what is the percentage if it is price or overseas factors?

Mr Stevens—That is a question that has been raised by various people: is it all just petrol or overseas factors? But if we strip out the petrol, if we do inflation the way some other countries do, core inflation, so you take out food and energy, there is a big debate over whether you should do that. But leave that aside and you still find quite a pick-up. More generally, the data that the staff prepare on measures of what we call underlying inflation, which is a way of trying to gauge the persistent component of inflation, show that they have picked up quite noticeably too. So, yes, petrol prices have done some of it and they are now actually going in the other direction, which will be helpful, and food prices have done some. But it is not just that; it has been more widespread than that, which is why it was such an important issue for us. I cannot off the top of my head dissect for you the percentage part of it, but I think, Malcolm, CPI ex food and energy is about 3½ per cent over the past year. Is that right?

Dr Edey—It is a little bit less than that, at about 3¼ per cent.

Mr Stevens—That is still noticeably higher than you see in other countries. Bear in mind, of course, that even to get that there are a whole lot of prices that fall every quarter. You cannot just take out the ones that are rising and say it is all okay. You should be even-handed and take out the falls as well.

CHAIR—Thanks, Will. Emily from Loreto has a question.

Emily—Governor, how difficult is it to set interest rates when the effect on cost and demand inflation is different with a restrictive stance?

Mr Stevens—Is different with?

Emily—A restrictive stance.

Mr Stevens—I suppose it is a complex thing to try to make monetary policy decisions, but I think there has been a demand component to inflation; that is the problem. If you observe an economy with capacity constraints clearly in evidence, demand is very strong and prices rise. I think you cannot draw any other conclusion than that at least some of this inflation is a demand
problem even though there were supply things at work. So you have to try to form a balanced assessment and make your decision accordingly, and it is very hard.

CHAIR—Thanks, Emily. We will have a short adjournment.

Proceedings suspended from 10.35 am to 10.47 am

CHAIR—We have two more schools here, Governor, so we will deal with those issues first before we get back into the more general questions. We have a question from Simon from Xavier College.

Simon—Governor, there was a lot of speculation before the Reserve Bank decreased the cash rate as to whether the major banking institutions would pass on these savings. How do you see monetary policy changing in the future to ensure that it remains an effective tool to manage the economy?

Mr Stevens—I think it will remain pretty effective. As I said in response to one of the earlier questions, even if the cash rate does not mechanically, point for point, lead to a change in lending rates, I think it still has quite a bit of influence over the general structure of short term interest rates in the economy. What we have seen, in fact, in the past few weeks is that the anticipation that the cash rate would fall, followed by the fact of it falling, did lead to a significant decline in a whole range of short-term rates across the economy. That is what made it possible for lenders to follow suit with their loan rates—and, indeed, some of their loan rates actually fell before we made our announcement last week. I think we are all learning to understand a situation in financial markets where linkages are not quite as mechanical as they once were, but there is still a linkage there. It has not gone away completely.

Simon—If the banks decide not to pass on future rate cuts, would the RBA take any action to ensure that these were passed on?

Mr Stevens—Let us wait and see what happens when and if that time comes.

Simon—Thank you.

CHAIR—The next question is from James from Camberwell Grammar School.

James—The exchange rate has fallen quite sharply in recent times. I was just wondering what you think the effect on inflation would be.

Mr Stevens—It can have an effect. Usually we find that the most direct impact of a change in the exchange rate, other things being equal, is on the price of petrol. That happens within literally a few weeks. On this occasion, of course, the US dollar price of oil has come down from nearly $150 to about $110 or $115 at the moment. So that has accompanied the decline in the exchange rate; therefore, two things are moving. All else is not equal on this particular occasion, but it does have an effect on prices. It has been helping us at the margin to contain inflation over recent years. It will be giving us less help in the future, by the look of it, if it stays where it is today. That said, it is very hard to predict exchange rates. We do not know what will happen—nobody does. It is just one of the uncertainties we have to try to take account of in making our
forecasts and our policy response. But it certainly is a very important price in the economy. I do not think what has happened to date is going to seriously derail us on inflation, though.

Mr CIOBO—I think back to when we have done these hearings previously. A lot of the language does not seem to have changed remarkably, although I think your outlook possibly has, insofar as in the past you have made comments about anticipating accelerating inflation. You have made comments about your forecasts on GDP growth, on employment and on how the terms of trade are still high. When I think about it, there is only one key difference that I can note. Several years ago you projected that inflation would become higher. You make the same prediction now in terms of it reaching five per cent by the end of this year. You spoke of a two-thirds increase in the terms of trade over five years. The forecast looks like it will probably stay like that. The key difference that I note seems to be your forecast on GDP growth. Is that the fulcrum upon which monetary policy settings have turned for this session?

Mr Stevens—We published a forecast in August. One of the things that have changed a bit in the past year is that we put out a bit more detail about those forecasts now in the public domain than we had been doing. That forecast was a little bit lower than the one we had in May, which would have been the forecast that we were running with last time we met the committee—only a little bit, though; it was a quarter of a percent, I think. As I said at the beginning, just based on the national accounts alone, there is certainly no reason to revise that down. If anything, things in the first two quarters of the year looked slightly higher than the pace you would expect if the forecasts for this year were to be realised. I am not saying that the forecast will not change from here, but hitherto we have had an outlook for about six months now that has said: ‘Yes, it is slowing down. We are going to have below-trend growth this year.’ Demand has softened in due course. Assuming that pans out, that will contain inflation even though we will not have the evidence of that for some time yet. Our outlook there has not changed greatly in the time since we last met the committee in Sydney.

Is it the fulcrum? Well, strictly speaking, in an inflation-targeting arrangement, the fulcrum really is, ‘What is the forecast?’ You should respond to the central forecast and have some sense of the risks surrounding that forecast. The GDP outlook certainly is a key thing that goes into forming the set of forecasts we have for inflation, though it is not the only thing. It is really that overall assessment that I think should be thought of as the fulcrum for policy. What has changed since we were last before the committee is that time has elapsed. Tight policy has been working, along with other things. Demand has slowed. We are getting closer to the time when we think inflation will start to come down, and we have said yes in anticipation of that and in recognition that this is a pretty tight stance that we do not want to hold any longer than necessary. It was time to make a downward adjustment, so that is what we did.

Mr CIOBO—Going back, say, two years ago, your predictions were similar in the sense that you obviously thought that, over the longer term, inflation would start to come down. If you had not thought that, then interest rates would have kept increasing, which obviously they did; but I put it to you that that is probably a consequence of the continued economic growth being above trend. Again, I make the point that, from what I can observe and from your statement, the inflation rate is forecast to increase and our terms of trade are forecast to increase. The only obvious comment that I can note from your opening statements and from the previous minutes is that there is a decrease in the pace of growth. Is that correct?
Mr Stevens—I do not think it is true that we forecast the terms of trade to increase from here. In fact, there is a chart in the most recent statement on monetary policy that shows them peaking here and actually coming off a bit. That assumption has been made by us and other forecasters every year for some years now and has been wrong so far, but my sense is that it probably will be right this time. They could be famous last words.

Mr CIOBO—That is a part forecast, then.

Mr Stevens—I do not think it is true that we are forecasting a further gain in the terms of trade. Instead of above trend growth and upside surprises on growth, we are seeing growth lower, and that is a key feature of the environment and it is important in informing the forecast for inflation.

Mr CIOBO—The key point that I would stress, though, is that you have moved from a neutral position on interest rates to actually easing monetary policy. This of itself is, to use your analogy, about changing lanes. Your most recent decision is a lane change. So I take it from that that your forecast of the risks associated with this position is that the risk is to the downside.

Mr Stevens—The economy is in the process of changing lanes; therefore, the steering has to be correspondingly adjusted—

Mr CIOBO—The car is still staying on the road.

Mr Stevens—so that we keep on course. What is the risk to growth? I can see downside risks, certainly. The global situation is highly uncertain. I do not think that confidence is as weak as you think it is, but it is softer than it was. There is no question that that is true. All that is true; all that is happening. One can think of upside risks if those business investment data were to come true, or anything like it. That would actually be a stronger outlook than we have got pencilled in, so I can think of things going the other way. It is simply that, at this point of the cycle, it seemed prudent, to me and to the board, to be pressing on the brake not quite so vigorously as we were—looking forward in anticipation of what we think is likely to occur.

Mr CIOBO—I am just trying to get a handle on what the key changes are, now that we have the RBA board taking a view that an easing of monetary policy is the right way forward. Based on what you have just told me, if business investment were actually to materialise, as is being demonstrated, the risks would be on the upside, so you have taken the decision to ease monetary policy. Again, I just do not understand what has changed remarkably in the last, say, 24 months if it is not GDP growth forecasts?

Mr Stevens—I think what has happened is that we have gone from a period where we were continuing to eat up spare capacity and exceeding capacity to one where we are now starting to slowly get some spare capacity back. It is lower demand growth. The tight policy is designed to slow demand. It has slowed. Once that occurs, you recalibrate to something that I would not call neutral. This is still well on the restrictive side of a neutral setting; it is just not as restrictive as it was. I think that is appropriate given the way the circumstances of the economy have shifted over the past six months.
Mr CIOBO—So the low point of growth, you said in your opening statement, would be lower than that—two per cent? You forecast two per cent. Are you—

Mr Stevens—The forecasts that we published most recently I think were for 1½ per cent for non-farm GDP through 2008. I think we might possibly take one quarter longer to get to that low point the way the data has panned out, but I suspect we will still get to that same low. That is lower than average. Subsequent to that, I think we will probably begin to pick up again. That is the outlook we published and, at the moment, I do not think there is much evidence in favour of a change.

Mr CIOBO—In terms of keeping a watch, from a policy perspective we are looking for: what were the preconditions for continued cuts to monetary policy, given that inflation is forecast in the near term to continue rising? I note in your opening statement that you made a couple of what I thought were key comments.

With demand growth slower, capacity utilisation, while still high, is tending to decline. Trends such as this usually dampen underlying price pressures over time, and those effects should start to become apparent during 2009 and continue into 2010.

This assessment hinges to no small extent on growth in overall labour costs not picking up further.

You went on to say:

With pressure coming off the labour market, an assumption that this behaviour will continue appears to be a reasonable one at this point, but it is a critical one.

I get the impression therefore that continuing easing of the labour market is absolutely fundamental as a precondition for further interest rate cuts.

Mr Stevens—I am not sure that I would say that per se. I think what is important is that the cost pressures that are going through the system now, but which should abate, are not then compounded by a sudden pick-up in the rate of growth of labour costs. So far, labour cost growth has picked up a little bit over recent years but, all things considered, with the tightest labour market for a generation, that has worked out pretty well so far in terms of being fairly contained. We are assuming that will still be the case. I think that is a reasonable assumption to make because I do think labour market conditions are easing, as we were talking about earlier, and any tendency for wages to pick up ought to be ameliorated by that. But if the labour market does not ease up and wages stay steady then that is great. That does not necessarily preclude interest rates going down a bit, provided that there is a good, credible story that inflation is going to be on the way down. That is, ultimately, the bottom line.

Mr CIOBO—Can I ask about the relationship between industrial disputation and productivity.

Mr Stevens—Do you mean: is there one?

Mr CIOBO—I am interested in your comments on any relationship that may exist between the two.
Mr Stevens—If a large chunk of the country were to be not working, presumably they would not be producing much while they were not working. I am not quite sure how you would measure output per hour for those people because there would be two zeros in the division. But say you are asking: is there a relationship between industrial disputation generally and the rate of growth of productivity? There may be. I am not aware of research on the topic, so I would not want to give a strong opinion one way or the other. There may be research but I am not familiar with it.

Mr CIOBO—And with GDP growth?

Mr Stevens—Disputes and GDP? If we were on strike, we would not be producing, so GDP growth would be lower. Demand would not be lower but supply would be.

Mr CIOBO—We have seen a significant up tick in industrial disputation in the first six months of this year in comparison to the previous five years, for example. Would it be reasonable to conclude that a consequence of that will be a continued moderation of GDP growth?

Mr Stevens—I think that might be a bit of a stretch. I am looking at the chart on disputes here at the moment. There has been an up tick. Just looking at that, I would not say that that is remarkably different behaviour from history really. It is a bit early to make that call at the moment I think.

Mr CIOBO—The number of days lost to industrial disputation in the first quarter was nearly equal to those for the previous 12 months. That is not a cause of concern?

Mr Stevens—The previous 12 months actually look very low on here. I am not saying it is not a matter of concern, but on the aggregate evidence this is a highly volatile series. I personally would not be inclined to draw strong conclusions from this from what I see here at the moment.

Mr CIOBO—If that trend were to continue?

Mr Stevens—A highly fractious, disputative set of conditions in industry is hardly helpful to confidence or growth obviously; that is right. I think we all know that from the history way back. Fortunately, for 20-plus years things have been much better.

Mr CIOBO—Governor, just with respect to business and consumer confidence, whilst I note your relatively upbeat assessment, I am mindful of the Sensis SME survey, which shows a collapse to 1991 recessionary levels of SME confidence. The OECD Standardised Consumer Confidence Indicator shows that Australia is the second worst OECD country and has collapsed since November last year. Finally, I refer to the Nielsen survey which measures global consumer confidence. That shows that the collapse of consumer confidence and business confidence in Australia has been twice as fast as in anywhere else in the world. Do you think that the collapse in confidence shown in those three key benchmarks is a reflection of concern over the RBA’s policy settings or some other factor?

Mr Stevens—Let us start with Sensis. Did Sensis exist back in 1991?
Mr CIOBO—Yes, it did. It may have had various guises.

Dr Edey—My memory is that it only goes back to 1993, but I am not certain of that.

Mr CIOBO—I am happy to direct it to 1993 rather than 1991.

Mr Stevens—On page 29 of our statement published in August there are some charts of business confidence and conditions measures. I do not want to endorse any particular commercial survey, but those are the ones we pay a fair bit of attention to. They certainly have fallen, but I do not think that is a collapse to early 1990s proportions. I am not familiar with the Nielsen survey.

What declining confidence might be due to—whether it is because people have lost confidence in the Reserve Bank—I do not know. Probably it is that we have a slowing economy, uncertainty, a weaker share market and a whole lot of global problems. Obviously, all those things matter to people’s sentiment. It would be surprising if they did not.

Mr CIOBO—We have been in this position before though. Looking at graph 36 on page 29 of your August statement on monetary policy, which I assume is the graph you were referring to, you can see business confidence there at minus 15, which at least puts it on par with the end of 1991 and the beginning of 1992. All the things you have just detailed to me are not unique. We have had that in 2001 and we have had it previously as well and we have not seen a collapse of confidence like this. I am interested in the board’s view as to what has caused this massive decline.

Mr Stevens—it is not on a par with 1991, with the low point of the recession. If it kept going then it might be, but what I would say about the board is that these are people who are pretty well plugged into the business community and I have not heard them speak of a collapse of confidence at all in any of the discussions we have had. So I have not heard that view expressed around the board meeting.

Mr CIOBO—Perhaps they should get out more, Governor.

Mr Stevens—I think they get around a fair bit.

Mr MARLES—Can I start by apologising, Governor, for being late this morning. I was taking my son to school down in Geelong.

Mr Stevens—I think that was probably more important.

Mr MARLES—He thought so. I am sure, if I ask you a question that you have already been asked, the chair will pull me up. I just wanted to pick up on a point Mr Ciobo was raising. Do you think that enterprise bargaining promotes labour productivity?

Mr Stevens—I think we have been around labour market and industrial relations a lot over the years at the committee. As I have said before, the move away from a highly centralised, rather rigid and legalistic set of arrangements to something which is more enterprise based, more market responsive, more flexible, seems to me unarguably to have been of great benefit to the
Mr MARLES—I want to ask you some questions about the international environment and how that plays out in the Reserve Bank’s thinking about monetary policy. In the most recent decision, how does the GDP growth, or decline, if you like, of many of the G7 economies factor into your thinking on monetary policy, and where do you see the terms of trade and the price of commodities going? There is a subquestion in that. I think I read in the material that your view is that the price of commodities is going to ease towards the end of this year, although I was not completely sure about that. Perhaps you might clarify where you see the terms of trade going. How does all of that play on your decisions about monetary policy?

Mr Stevens—On the terms of trade question, there is actually a chart on page 60 which has the assumptions that are being made. You will see there that it reaches a peak and it is assumed to tail off because of some declines in the prices—I think mainly of metals—that were already in train. Malcolm, do you want to add any detail about terms of trade outlook?

Dr Edey—Basically we think that the terms of trade will fall by around five per cent in the coming year. Basically what has happened in the past six months or so is that we have locked in a set of higher prices for the bulk commodities. The outlook for those is still good. Spot prices for coal and iron ore are still above the current contract prices, so there is a fair likelihood that those prices will stay high in the year ahead. But those markets have softened in the last couple of weeks. I think we are seeing the effects of the slowdown in global growth starting to come through in those markets and probably also the effects of the expanded supply putting some downward pressure on prices. But in metals markets generally we are seeing prices off their peaks now. I think that is consistent with the forecasts that we have made in the statement.

Mr MARLES—Do you still see coal and iron ore doing well?

Dr Edey—Spot prices for those are still above current contract prices, but they are coming down. Obviously we do not know how far that is going to go, but I think that is being driven by a slowdown in growth in China and other parts of East Asia, so as the global slowdown spreads to those other parts of the world I think that does put some downward pressure on those bulk commodity prices.

Mr MARLES—So, Governor, given that assessment, and the decline in a number of the G7 economies and also a slowing of the growth of GDP in East Asia, could you give some more comments about how that all factors into your decisions in relation to monetary policy?

Mr Stevens—The shape of the world economy matters through trade channels, obviously; it matters for the prices of energy and resource commodities, and there are a number of ways those have an impact on us—through the terms of trade and the resource sector; energy prices affect consumers and businesses and so on. So all those things matter. Also, the shape of the world economy elicits policy responses, which affect financial prices. So there are a whole mix of things that go in there. As to the 2008 outcomes for the global economy, recently the IMF actually revised up their 2008 outcomes. Now that, I think, is basically the strength in the early part of the year that I talked about earlier, which was unexpected. Their 2009 forecasts are starting to come down a bit, and I think that makes sense. We have already had a lower forecast
there than many others. So, at this point, we would be assuming below average growth for the global economy next year—not a complete crash, but below average—and I think probably that is helpful from the point of view of dampening pressure on prices.

**Mr MARLES**—I also want to ask you a question that I think was probably asked when we last met, but, given the effluxion of time since then, I want to ask you what your thoughts about this are. Looking back at the US subprime crisis—and, given our borrowing practices here in Australia, we are obviously far better and more robust—to what extent do you think it was predictable? To what extent could we have better prepared for what occurred in the US? Maybe a better way of putting that question is: what lessons could we in Australia learn from it, in terms of the future? Are there any, in the sense that maybe our lending practices are fine here? This far down the track, what are your thoughts looking back on the US subprime crisis and its relevance to us?

**Mr Stevens**—There is a long answer and a short answer to that. Let me give the short, more contained answer first. I think lending practices generally here did not deteriorate to anything like the extent seen there. We did, though, have some fringe players in the mortgage market, typically funded by securitisation channels, who had standards which showed—while they were not as bad as those have turned out to be in the US—they were prepared to take considerably more risk than the more established lenders were. And I think those sorts of loans are disproportionately represented among the households where there really is serious stress—and there clearly is some in some areas. I think we are fortunate, to be honest, that the turn of events that we have seen internationally has closed off that type of lending. Had that gone on for five more years, we could quite possibly have, I think, ended up in a situation where there would have been a lot more of that type of lending here than we in fact saw. I suppose it is, in some ways, fortunate for us that the Americans fell over when they did, from that point of view. So that is good.

Two years ago, at this committee or its predecessor committee, we spoke about a sense that lending standards were tending to decline over time and that you would see, as a result of that, higher arrears rates on some of these loans, and we do indeed see that. At this point, that is a rise but it is contained. In fact, on the balance sheets of the big banks the arrears rates are actually still pretty low, because they did not do as much of that more risky lending. The arrears rates mid this year are about the same as they were last year, having gone down a bit in the interim.

I think a lesson for everybody around the world is how much trouble you can get into when you have poor standards, a misalignment of the incentives for the people actually writing the loans—it was not their money so their incentive to write a loan that would be repaid was almost certainly rather less—and, of course, the global search for yield, which is the other part of the backdrop here. There is a long answer I will not go through, but we had a long period where, globally, interest rates were very low, there was a lot of capital searching around for something to do, the yield on normal things had been bid way down and clever people came up with other ways of earning yields, which were claimed to be pretty low risk but which turned out to be more risky than was claimed. That is part of the global backdrop. I think those days are now gone, but that was, on the supply side, as big a problem as the quality on the demand side.

**Mr MARLES**—In saying those days have gone, is your implication that the lesson has been learnt in the US?
Mr Stevens—When I say they are gone I mean I think those days of very easy credit, search for yield and so on will not recur any time soon. They will recur one day, because I think history demonstrates over and over again that, given long enough, people forget the lessons. A new generation of lenders and borrowers come in and the cycle goes on, as it always has. They are not gone forever, but we had a period of very cheap pricing for risk, which has now passed, and things are more expensive. Phil, do you want to add anything on the stability front to that?

Dr Lowe—Just to reiterate what Glenn has been saying, we have been through a period where we have had very low global interest rates, low and declining credit standards and investors who were prepared to buy all sorts of financial paper based on the ratings the credit rating agencies had given them. That was a powerful combination that allowed a lot of people to borrow on rising asset prices. Those days are clearly behind us, at least for the time being. But, as Glenn said, we live in a world where there are big financial cycles. No doubt these problems will re-emerge one day in the future in some different form. One financial episode is never like the last, but there is a recurrence of boom and bust and we are living through the downside of that now.

Mr Stevens—For some years, astute observers grumbled and made complaints that pricing for risk was too cheap—‘There’s something wrong here; something will go wrong somewhere.’ I do not think very many people, if anyone, were able to say: ‘It will go wrong in the US housing market. Early in 2007 is when it will start.’ No-one that I know, anyway, picked it that well. There was just a general sense that yields were low, compensation for risk was incredibly skinny and something was not right. That will not recur soon but, as Phil said, there are low-frequency swings in financial behaviour and there are actually some quite big policy issues that arise from them for regulators and central banks globally. We do not have time to go into it today, I guess, but it is a very important set of issues.

Mr MARLES—You mentioned today in the answer to a number of questions—and I think it is also in your statement—the capacity constraints which exist within the Australian economy. For how long have those capacity constraints been exercising the attention of the Reserve Bank?

Mr Stevens—I do not remember exactly when it was that we started to use those terms in public, but it was a few years back. That is a picture of an economy, having had a long expansion, starting to run into buffers. In some senses, it is a sign of success—by which I mean you actually want to be at full employment. You do not want to have huge amounts of spare capacity in the economy. But once you get to the buffers you have to slow down to not overdo it. That is what we were trying to say and trying to achieve. Now I think capacity constraints are easing a bit across a number of sectors. That is what the surveys are telling us. That is what you would expect if output growth has slowed down and will likely stay more modest for the next little while. The capacity constraints ease up; therefore the inflation pressure eases up and so on.

Mr DUTTON—Governor, I want to start by touching on a statement in your opening statement. You said words to the effect that ‘this has led the board to begin raising rates from unusually low levels’. You touched on this a moment ago in terms of some of the international factors but, domestically, what do you think caused rates to get to those unusually low levels? Why did we come off that base?

Mr Stevens—This was way back seven years ago, when there had been a G7 recession. We had had a slowdown. Inflation fell, rates came down and they got down to levels well below
normal. My predecessor was always of the view that once you had done what was needed to support growth in a wobbly period, once that had succeeded, you did not leave those really low rates in place for too long, because you will get in trouble. So we started to edge them higher, a process that went on for some years.

Again, it is this notion that the application of the instrument causes a change in direction, but when the changes happen the instrument has to then be recalibrated. Otherwise, you will go too far in the directional change. That is what we are talking about, and what I am saying is that it is that same thinking, same mode of behaviour, that has now had us feel that, yes, with the really high rates we have achieved what needed to be done there and we should not leave them in place any longer. Otherwise, they will start to be too damaging. So we eased them down a bit. What I am trying to say is I think that that is symmetric with how we behaved at the other end of the cycle and indeed how we have behaved at the peak of previous upside interest rate cycles.

Mr DUTTON—You touched before on some of the capex figures that came out recently, but how does the RBA reconcile rapid growth in capital spending and strong profits with poor business conditions in the various business surveys and weak credit growth?

Mr Stevens—That is actually the question: how do you reconcile apparently conflicting pieces of data? I think part of the reconciliation will be that in a year’s time, when we find out what the capital spending actually was, it will not be as strong as a literal reading of these recent data suggests. However, without wanting to get too technical, the way forecasters use this data is we have a history of the extent to which expectations were realised going back through history and we apply a realisation factor based on that history.

If you apply the realisation factors we have had in recent years, you will get extremely strong growth in capex spending. If you apply a recession year realisation, you will still get a little bit of growth. What we will do, I think, is apply neither of those extremes and come up with what will still be probably a pretty solid outcome but not as strong as the literal reading would suggest.

As to the broader question of how you reconcile conflicting pieces of data, every month there will be conflicting bits of data somewhere or other. Really, the economy is a giant jigsaw and the pieces fit together in more than one way; the question is how you fit them together in a way that seems to make the most sense and then go from there. That is what Malcolm’s staff, Phil’s people and John’s people spend most of their time doing—trying to work out how these disparate things come together to form a picture that makes sense.

Mr DUTTON—Just to add to that dilemma, does the negative result for household spending in the national accounts in the June quarter point to a trend or what is a one-off?

Mr Stevens—I think it is likely that household spending as recorded will still be pretty subdued in the near term. That is pretty likely, I would say. I do not think it will likely weaken much further from there unless something much bigger and untoward happens in the rest of the economy. But it certainly was a subdued figure, and we knew that it would be, based on retail sales data we had and based on our discussions with retail firms—which we do intensively with all of the big retailers and a selection of smaller ones every month.
As we were saying earlier, there is a contrast between the weakness in household demand and very strong growth to date in business investment spending and a fair amount of strength likely, according to those data we were just discussing. So that is quite a contrast in the economy. Which of those forces will win out? That is a key question, and a highly uncertain one.

Mr DUTTON—Again, following on from your comments about China—stemming from questions from Ms Owens—how does the RBA assess the risks around China’s growth?

Mr Stevens—China is slowing down. China wanted to slow down and needed to slow down. There has, I think, been pretty clear evidence of overheating in that economy. How far will they slow? I do not know. The latest growth figure would be about 10 per cent over the year. I think most forecasters probably have a slightly lower number for the year ahead but still not that much lower. Another question which is important for Australia is the extent to which China suffered from the loss of exports to the US and Europe. They clearly have suffered, and I think we can see that in the figures.

Obviously the resource sorts of things we sell them go into those exports but it also goes into the enormous domestic infrastructure build-up that they are undertaking. You have all been there. It just hits you; you can see where a lot of the coal, iron ore and so on ends up. My guess is that they will continue to do all that for some time and, indeed, if they start to worry that the economy is slowing too much, they will actually increase that pace of infrastructure build-up. How that all pans out for our commodity prices is an important question, and I do not really know the answer—I do not think you can know. But the assumption we have made anyway is for some modest decline in the terms of trade in the year ahead—after five phenomenal years.

Mr DUTTON—I would like to ask you a question relating again to the statement that you made. You said on page 4 of your statement that ‘infrastructure and mining build-up are often struggling to keep pace.’ If the infrastructure market domestically were to be fuelled, say, to the tune of $40 billion over the next three or four years, what inflationary impact would that have? How would that impact on your considerations?

Mr Stevens—It depends what else is going on, obviously. I do not think there is any doubt about that build-up, in which the private firms that are doing it see a profit opportunity and are pursuing that. The governments—mainly at state level—that are doing their own infrastructure build-ups see a need for this urban infrastructure that I think we clearly do need. It has to be done at some point. That does use resources. All other things being equal, it adds to pressure on construction costs and so on. Other things have not been equal; other things are slower. The trick is to try to have the aggregate at about the right pace—which, right at the moment, I think it is.

Again, there is this theme that business cap expending and some forms of government related cap expending are very strong. Household spending on consumption is soft. If you add those two together you have quite solid growth in demand in the economy, but it is slower than it was a year back. That needed to occur because we were pushing inflation up the way we were going.

Mr DUTTON—You said in your answer that where inflation is at the moment is okay. If—for argument’s sake—you were to pump $10 billion a year over the next four years—

Mr Stevens—Ten billion dollars more than is currently—
Mr DUTTON—More than what is currently—

Mr Stevens—Ten billion dollars—

Mr DUTTON—What are the inflationary pressures there?

Mr Stevens—is a little under one per cent of GDP—let us call it one per cent to make the numbers easy—so you would be adding one per cent of GDP to the level of demand compared with the current outlook that we have in this hypothetical scenario that you are talking about. We already have built in the build-up of infrastructure that is going on and that we can see at the present moment based on companies’ plans and what we know of government plans. If you are talking about another one per cent of GDP on top of that, then that adds to demand and, all other things equal, if that occurred and nothing else was slowing down, then that would surely make it harder to reduce inflation in the way that we need to.

Mr DUTTON—I also have a question on this inflationary theme. Would not increasing consumer taxes by $6 billion over four years add to inflationary pressures?

Mr Stevens—Is this not increasing taxes compared with what is presently assumed? Six billion dollars over four years is a billion and a half per year, so that is about one-tenth as big as the other number you were just quoting. I see here that we might be getting into current discussions over the passage of the budget through the upper house, and I would rather not step into that particular minefield, if you do not mind.

Mr DUTTON—that is unusual!

Mr Stevens—I am missing a few limbs, but I would like to keep what is left.

Mr DUTTON—I refer you to page 31, table 9 of your statement of August. You are talking there about the fiscal balance of the general government sector. I am trying to get an understanding of the impact here. The table compares 2007-08 to 2008-09 for the federal government. You have $20.4 billion in 2008 and $23 billion 2009. When you add the states in, if you compare it on a per cent of GDP—1.4 per cent—it levels out across 2007-08 to 2008-09. I wonder, therefore, when you take into consideration the debt of the states—and certainly in New South Wales, and perhaps elsewhere, with the precarious position they are in at the moment—and that levels out any surplus delivery by the federal government, what impact does that have on your decision making in relation to interest rates?

Mr Stevens—to the extent that we can evaluate all these trends—and our evaluation is here in the material that you quote—that has been taken into account, as best we can, in the decisions we have made up to date. Should trends start to diverge markedly from this for some reason, then obviously we would have to form another evaluation; and important in forming that would be why the changes happened. If any have happened because the economy slowed more, that is different from if it happened because there was a sudden desire to embark on much more spending, even in an economy that was going okay. They are different cases, obviously. I think the answer is, thus far: this picture here is, roughly speaking, the set of assumptions on which we have been operating up to now.
Mr DUTTON—I think our time is going to beat us, but I want to ask one more question. I want to take you back to graph 36, on page 29, which you made reference to earlier—specifically the second part of that graph, which is ‘business confidence’. I am trying to reconcile your comments before to the evidence which is provided by the graph. If I could take you to the current point, which comes out to 2008, it shows it at negative 15. Is that on your graph?

Mr Stevens—This is in the middle panel?

Mr DUTTON—Yes. It says negative 15. Is that what you read?

Mr Stevens—Yes.

Mr DUTTON—If you go back from 2008, there is an orange line—the NAB survey—and a purple line, which represents other non-farm sector surveys. I do not see the position of business confidence achieving that negative 15. If I take you right back through to 2004 and to 2000, it still was not as bad as business confidence is today. If I take you back to 1996, it was nowhere near what it is today at negative 15. If I take you back to 1995, 1994, 1993, 1992—it still was not as bad as it is today at negative 15. Perhaps if I get back to 1991 it is at negative 15. I am wondering how, if my reading of that graph is correct, that supports the evidence that you gave before.

Mr Stevens—I am saying that business confidence has come down. I think, regarding the differences between what we see thus far and what we see in some of these other episodes, the number is a bit lower, but I am not sure that is a major statistical difference. It is true that it was minus 15 in 1991. By that stage we had had a recession, actually. By this time of the year in 1991 the recovery was underway. I do not think this is going to be like the early 1990s again. I think that is highly unlikely. Confidence is down, though. The top panel shows what they say is actually happening as opposed to what they feel; I am not saying what they feel is unimportant, but what is happening on the ground has come down to a bit below average, and it is probably going to go a bit lower. I think that is happening now.

Mr DUTTON—I am saying that business confidence has come down. I think, regarding the differences between what we see thus far and what we see in some of these other episodes, the number is a bit lower, but I am not sure that is a major statistical difference. It is true that it was minus 15 in 1991. By that stage we had had a recession, actually. By this time of the year in 1991 the recovery was underway. I do not think this is going to be like the early 1990s again. I think that is highly unlikely. Confidence is down, though. The top panel shows what they say is actually happening as opposed to what they feel; I am not saying what they feel is unimportant, but what is happening on the ground has come down to a bit below average, and it is probably going to go a bit lower. I think that is happening now.

Mr DUTTON—The point I would like to make, though, is that if you compare us to other OECD countries, as Mr Ciobo and Mr Keenan pointed out before, Australia is second only to Spain in terms of that lack of confidence. By your own graph 36, that we just referred to, it shows negative 15. If you go back to 2001 or 2002, it was at about positive 12. So it is a 27-point turnaround on what you have provided by way of your graph.

I just wonder about the position that we find ourselves in at the moment as to why small businesses cannot get credit from banks and larger businesses are finding it very difficult to expand—in fact, many of them are contracting and putting staff off and casual staff are having their hours slashed. I find it amazing that we would not point to business confidence and, in particular, a distinct lack of confidence in the economic management of this government—that that is not a real reason why we are finding ourselves in a deeper position than some other countries whose economies are certainly not as fundamentally strong as ours is.

CHAIR—I am not sure if that was a question or a statement.
Mr DUTTON—I am happy to hear the answer.

Mr Stevens—I am not able to comment on the OECD survey; I have not got that there. I will look into that. If there is a credit problem with banks being unable to extend credit, there does seem to be a global issue of that nature around. I think our banks are much better placed than most banks in the major countries, but they certainly are showing more caution now.

Mr DUTTON—Why, when our economy is fundamentally strong—

CHAIR—Mr Dutton, I think you said three questions ago that it was your last question.

Mr DUTTON—I was very patient through your contribution at the start, Chair—

CHAIR—You may have been.

Mr DUTTON—so if you were able to extend a little bit of courtesy that would be great. I would be happy if the governor could finish on that answer.

CHAIR—This will be the last question.

Mr Stevens—I think that, in some fundamental sense, the situation in this economy is not bad and is not going to be as bad as in a number of others we could name, and I think the reasons for that should be fairly apparent. We do not escape totally unscathed from a global credit issue. What we can hope to do is to do a fair bit better than others. Credit in this economy is actually still growing; it is not shrinking. It is growing much slower than it was, but it was almost certainly growing too fast. We do not see a credit crunch of anything like the proportions that we have once or twice seen in the past, and I do not think we will; at least, that is the evidence as I see it at this point.

CHAIR—Thanks, Governor. What we will try and do now is to have one question from everyone and see if we get through that. I would like to go back to ask you a question on fiscal policy, briefly. So far as monetary policy is concerned, is the slowing in growth of government spending helpful to the task that you have in terms of keeping inflation under control?

Mr Stevens—I think the main thing is that the country needs a credible fiscal policy in terms of budgets year by year and sustainable debt, and we clearly have that. There has been some restraint in spending, I know, in some areas at the Commonwealth level, although, as I have said repeatedly today, final spending in the national accounts by the government sector in aggregate is actually rising pretty smartly, and a lot of that is owing to the infrastructure build-up that is taking place that state governments have judged to be needed.

Mr PEARCE—Governor, you mentioned this morning that you think Australians are doing it tough. We have been told that the risk of Australia going into recession is high. In your statement you said that household spending is soft, that inflation is going to remain uncomfortably high and that there has been a tightening of financial conditions and credit standards. You said, just before, that the economy was growing too fast. In the statement, you said there is a picture of moderating demand. Grocery prices are high; petrol prices are high. You say in your statement that we are six months away from seeing clear evidence that inflation has begun to fall. I guess
that when Australians look at you—and I mean this with the greatest respect—in a way they see you as one of Australia’s financial planners, your role is so critical to the financial and economic system of Australia. So, if you could put on your financial planner hat, what advice would you give to a couple in an electorate like mine, which is—in addition to being the best electorate in the country!—very much a microcosm of Australia? What advice would you give to a young couple who are a two-car family and have a couple of kids—a couple who got in the car this morning, set off, dropped the kids at school and set off to work? What advice would you give them about their planning and their level of confidence into the future?

Mr Stevens—I am not in a position to offer detailed financial advice. But I would say that there are a lot of reasons to be confident in the future of this country. I think we all actually agree with that. We are going through difficult times at the moment but we have got to try to navigate through some fairly tricky areas and accept some slowing in our economy for a while in order to safeguard the stability of our money in the longer run, and it would be very damaging to this couple if we failed to achieve that. That is my message. I realise that that is not necessarily a terribly popular message, but that is what we are trying to achieve. We are trying to achieve a path that slows the economy down, does not have a crash; gets inflation under control, does not just let it go; and leaves us, in two or three years from now, nicely set for the ongoing future of good expansion, steady low inflation and interest rates back to normal levels. That is the path I am trying to get us onto, the path that the board is looking for.

Mr BRADBURY—Governor, I know that assistant governor Dr Lowe recently gave a speech to the annual Retail Financial Services Forum and there was an interesting section in that speech that related to the broader issues of trying to deal with the financial cycle. There were two elements of that particular passage that perhaps you could elaborate on. One related to the issue of remuneration within financial institutions and the extent to which there are concerns that these remuneration packages are structured in such a way as to encourage short-termism, and that that may potentially leave the economy open to some risk in managing the financial cycle. The other element related to the argument for preserving capital buffers during the good times so that, when the inevitable not so good times were to arrive, institutions would have a greater capacity to deal with those less than good times. I wonder if you could elaborate on those issues and what regulatory responses may potentially emerge for government in the future.

Dr Lowe—Was the question directed at me?

Mr Stevens—I think you should take it—it was your speech! My predecessor occasionally answered questions about my speeches, but I am going to let you answer on yours.

Dr Lowe—If I can take the second issue first, this is the idea that in the banking system in the good times, when profits are unexpectedly high because there have been little credit defaults, some of that extra profit should be built up or retained on the balance sheets of banks to then be used when the credit losses actually materialise. This is an issue that has been floating around the international financial forums for a number of years now because people have looked at what has happened over recent years and seen the very high levels of profits essentially distributed to shareholders in the form of dividends and there is a disquiet in some quarters that that has actually happened. The issue is: how do you actually address this? How can regulators and banks themselves retain some of the extra profit on the balance sheets in the good times so it is available in the bad times? It is fundamentally difficult. I think it requires, if we are going to
make progress here, an international agreement because it is very hard for one country to do that by itself. It also increases the probability that financial intermediation will occur off the balance sheets of banks. As we saw in the past, when you put too tight requirements on banks the lending gets done elsewhere in the financial system rather than on banks’ balance sheets. So that is another issue that needs to be confronted if there are going to be developments in this area. It is something that is right on the top of the agenda in the international forums, and people are giving it serious thought, but it is very difficult.

My remarks about remuneration reflect the sense in many parts of the community that many people in the financial sector, particularly in the US and in Europe, got very well remunerated through the recent bull run in the financial system—that they get paid out and then they leave when the problems occur. Many people are rightfully unhappy with that outcome. The other issue here is that the remuneration arrangements tend to be linked to short-term performance, and many of these risks that we are talking about really materialise only in the medium term. So there is a sense that we need to have remuneration arrangements that key off medium-term risks and medium-term outcomes. But, like the first issue, this is fundamentally difficult. How do we redesign the remuneration arrangements in financial institutions? This is something that the market determines, so it is very hard for regulators to do anything about it, and it is actually hard for financial institutions to do something about it as well. But, again, it is on the agenda in the international forums, and through that discussion hopefully we will make some progress.

CHAIR—This will be the last question.

Mr KEENAN—I want to ask something specifically about the quality of the information that you receive at the bank. Because of budget cuts, the ABS is significantly reducing the sample sizes of the surveys that it does—labour force and retail trade, for example. Does that present any concerns to you? Because of that reduction in sample size, is there a danger that the bank might underestimate the severity of the downturn?

Mr Stevens—Or overestimate it. Clearly we want the best quality statistics that it is possible to have. Generally speaking, it is well accepted internationally that Australia has high-quality statistics. In some ways I would prefer the quality to be increased further, if possible, rather than having to have any diminution. But it is the Statistician’s job to allocate his budget according to how he sees it. I think what he has said is that any decline in quality of the sample size would be very small, so in his view the quality of the data remains pretty high. Is that what the ABS have said, Malcolm?

Dr Edey—Yes.

Mr Stevens—Obviously we want good data and I am sure they will give us the best data that they can with the resources that they have to do so.

CHAIR—Mr Stevens, Mr Broadbent, Dr Edey and Dr Lowe, thank you for your attendance here today.

Mr Stevens—Thank you.

Resolved (on motion by Mr Pearce):
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 11.58 am