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Members: Mr C Thomson (Chair), Mr Briggs (Deputy Chair), Mr Billson, Mr Bradbury, Mr Fitzgibbon, Mr Hartsuyker, Ms Jackson, Ms Ley, Ms Owens and Mr Turnour

Members in attendance: Mr Billson, Mr Briggs, Mr Bradbury, Mr Fitzgibbon, Ms Jackson, Ms Ley, Mr C Thomson and Mr Turnour

Terms of reference for the inquiry:
  To inquire into and report on:
  Reserve Bank of Australia annual report 2009
Committee met at 9.31 am

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

LOWE, Dr Philip William, Assistant Governor, Economic, Reserve Bank of Australia

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

CHAIR (Mr Craig Thomson)—I declare open this hearing of the House of Representatives Standing Committee on Economics, and welcome representatives of the Reserve Bank, members of the public and the media. I also extend a welcome to the students and staff from East Hills Girls Technology High School, the Canberra Girls’ Grammar School, the Canberra College and Canberra Grammar School. Since the last public hearing with the RBA on 14 August 2009, the policy cash rate has increased by 75 basis points. While the RBA kept the cash rate on hold at its last meeting, the governor stated that:

If economic conditions evolve broadly as expected, the Board considers it likely that monetary policy will, over time, need to be adjusted further in order to ensure that inflation remains consistent with the target over the medium term.

The committee will examine the RBA’s assumptions for the economic growth, focusing on inflationary expectations and unemployment. The committee also notes the comments made by the deputy governor on 16 December about bank funding and, in particular, the point that other interest rates relative to the cash rate have increased by 100 basis points, which takes monetary policy into:

… the normal range, though in an expansionary segment of that range.

The committee will explore this point in more detail. In concluding this opening statement, on behalf of the committee I would also like to note that this is the 50th anniversary of the Reserve Bank of Australia. On 14 January 1960 the RBA commenced operations under its first governor, Dr HC ‘Nugget’ Coombs. The committee notes the contribution the RBA has made to the stability of the Australian economy and looks forward to its continuing contribution in the years ahead. The governor will have the opportunity to comment on some of the RBA’s significant challenges over the last 50 years and key developments in monetary policy instruments, such as the introduction of inflation targeting. In relation to this point, the committee notes that the recent International Monetary Fund staff paper has proposed that countries consider adopting a higher inflation target range in normal times. We may seek your views on this matter.

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 contempt of parliament. Mr Stevens, would you now make your opening statement before we go to questions.

Mr Stevens—Thank you, Mr Chairman and members of the committee. Happy new year to you all. I am pleased to be here to talk to you today. Since we last met in August, the global economy has continued an expansion that began around the middle of 2009. It appears that
world GDP grew at an annualised pace of about four per cent in the second half of last year. Many forecasters now expect a similar result to that in 2010. International financial markets have generally continued to thaw, with most capital markets functioning again and the use by large banks of exceptional support from central banks and government guarantees being wound down. These are, needless to say, very welcome developments. That said, some challenges do remain in the international situation. I will mention just two.

The first of them is the two-speed nature of the global upswing. Normally after a large recession, the ensuing upturn is also typically quite sharp. That has been the case in a number of countries in the Asia-Pacific, which of course takes half of Australia’s exports. That strength is not confined to China: India, Korea, Singapore, Taiwan and others have all seen a significant pick-up in production and trade. In a number of these cases the term ‘V-shaped recovery’ would certainly be apt. In this region, secularly rising incomes, generally healthy banking systems and relatively low public debt levels allow considerable room for confidence of a sustained expansion in demand. In fact, in some cases overheating is becoming the issue and, as you probably know, the authorities in both China and India have begun to tighten their policy settings.

In the large industrial countries, on the other hand, the rebound has been more tentative, and more driven by the turn in the inventory cycle and temporary policy measures than a strong pick-up in private demand. It is not unusual, at this point in the cycle, for that to be the case, for the inventory dynamics to be prominent. Nonetheless, the question is the extent to which a durable upswing in private final demand will become established. Most observers still expect that to be a fairly gradual process, given the lingering effect of the strain on banking systems and ongoing de-leveraging, not to mention the need, at some point, to begin the process of fiscal consolidation. Growth in these cases is therefore expected to remain modest and, as a result, these economies—the large industrial countries—are likely to be characterised by quite a lot of spare capacity and ongoing high unemployment.

So the shift in the centre of economic gravity to the Asian region is continuing, and if anything it has been highlighted by the different performances in the crisis and the initial recovery. The differences in speed of recovery between the emerging world and the advanced world, and the likely persistent differences in growth trajectories into the future, will I think increase the pressure on exchange rate arrangements in the Asian region.

The second challenge internationally is the increasing focus on sovereign creditworthiness. We saw a brief period of turmoil regarding Dubai late last year, and more recently the public finances of Greece have been under the spotlight, with those of a few other European countries just in the background. Going beyond just those instances, government balance sheets in numerous countries have taken on considerable burdens as a result of the crisis, and markets are beginning to focus on issues of sustainability. It will be a very delicate balancing act for those countries to strengthen their fiscal positions without of course undermining the strength of the economic upswing they are seeing.

Happily, in both these areas, Australia is relatively well placed. We are located in the part of the world that is seeing the most growth. And in terms of fiscal sustainability, Australia’s position is, by any measure, very strong indeed. Turning, then, to Australia, we think on the basis of data that is available thus far that real GDP grew by about two per cent through 2009. We
expect that it will grow by a bit over three per cent for 2010 and about 3½ per cent in 2011 and 2012.

What is driving that? Notwithstanding reports of patchy retail sales through the Christmas period, we judge consumption to have held up reasonably well after the various fiscal boosts faded. But in the future I think consumption is unlikely to be the leading driver of growth in the way it was a few years ago. Households I think seem to be adopting a more cautious position regarding saving and borrowing, which is appropriate.

A turnaround in private housing construction is underway. The effect of the temporary first home buyers boost is fading, but underlying demand is solid as population growth is strong and there is something of an underhang, so to speak, of earlier low construction to work off—that is, we were not building enough dwellings for a couple of years. Credit costs and availability of credit are adequate for households. For developers credit remains difficult to access, but it looks like we have seen a turning point in approvals for multi-unit construction. Housing prices, as you know, have been rising quite smartly over the past year.

Government spending is having an impact on demand, holding both residential and non-residential construction at higher levels than they would have been at if based on private spending alone. This effect will gradually diminish over the next year. At the same time, a large build-up in energy and resource sector investment is underway, prompted by optimism about long-run prospects for resource demand. The terms of trade are rising again after last year’s sharp fall, as the strength of demand has pushed up key commodity prices. In 2010 the terms of trade could once again reach a very high level, a level in fact exceeded in modern times only by the extraordinary level seen in 2008.

Inflation has been falling, in line with recent forecasts. It is important to remember that inflation reached five per cent at one point in 2008, or just over 4½ per cent in underlying terms. This was much too high. But the earlier period of tight monetary policy and the weakening in demand in late 2008 associated with the intensification of the financial crisis have seen inflation come down. Over the past year, it was about two per cent on a CPI basis and about 3¼ per cent, we judge, in underlying terms. Over the past six months, underlying inflation ran at an annualised pace of under three per cent. We think it will be about 2½ per cent in 2010. It is normal, given the lags in the inflation process, for inflation to keep coming down a little bit even as the economy has begun to firm.

With the economy having had only quite a mild downturn, however, we start the new upswing with less spare capacity than would typically be the case after a recession. One measure of that is that the rate of unemployment peaked at less than six per cent, much lower than we or most others had forecast. Only a few years ago, unemployment rates like that would have been seen as a good outcome in strong times, let alone in times of economic weakness. The general flexibility in the labour market, including the ability of firms and employees to adjust hours of work, limited the rise in the numbers unemployed. But also the overall size of the downturn in economic activity proved to be considerably smaller than was thought likely a year ago. This is of course a very good outcome. But it also means that there is less scope for robust demand growth without inflation starting to rise again down the track. Monetary policy must therefore be careful not to overstay a very expansionary setting.
This situation is quite different from those faced by the major economies. Whereas many of them had their worst recession since World War II, we had probably our smallest. As such, it should not be surprising that Australia was among the first countries to begin raising interest rates, once it was clear that the danger of a really serious contraction in economic activity had passed. The board, as you said, Mr Chairman, lifted the cash rate in October, November and December.

Most lenders raised borrowing rates by a little more than the cash rate. Allowing for those margin changes, borrowing rates are still below average but not by as much as the cash rate is. We have taken careful note also of non-price credit conditions. For large firms, access to capital market funding, both debt and equity, has been good. For some other business borrowers, access to credit has remained difficult, though we are seeing suggestions in our liaison now that this may be starting to ease. Furthermore, it appears that the rate at which lenders are having to make provisions for bad loans has slowed noticeably. That is not surprising, given that economic conditions have been improving. Given that, it is reasonable to expect that lenders will probably become more willing to lend over the coming year.

That said, it seems unlikely that we will return to the easy credit conditions of three years ago. The world has changed, at least for a while. Moreover, the likely course of international standards for regulation over the next few years will probably, at the margin, act to raise the cost of intermediation by requiring banks to hold additional capital and liquidity.

If economic conditions evolve roughly as we expect, further adjustments to monetary policy will probably be needed over time to ensure that inflation remains consistent with the target over the medium term. This is a normal experience in an economic expansion: as economic activity normalises interest rates do the same—though of course it is the interest rates borrowers actually pay, and that savers receive, that are important, not so much the cash rate per se. And the board sets the cash rate with that in mind.

Mr Chairman, I have said previously in these hearings that I thought Australia would come through the global crisis well placed to benefit from renewed expansion. For a time, the challenge was to sustain confidence, to support the economy and the financial system through some exceptionally demanding circumstances. By and large I think those efforts were successful. Now we must turn our attention to the challenges of managing an economic expansion. Issues of capacity, productivity, flexibility, adaptation to structural change and so on will all come back to the fore, as they should. For our community to tackle those challenges successfully, one important condition is monetary and financial stability. The Reserve Bank will do all it can to secure that. I look forward to your questions.

CHAIR—Thank you, Governor. The way we will do questions today is to go up and down the table, but if anyone has a follow-up question—and I stress one follow-up question—then I am happy to take that. Otherwise we will just go chronologically, Governor, at past hearings you have spoken about the emergency levels the cash rates have been to and then at our last hearing there was discussion about a move back to normal rates. The deputy governor spoke on 16 December about rates being in a normal range now, albeit in an expansionary segment of that range. The question that everyone out there in mortgage land wants to know is how close to your definition of normal are we now and what sort of prospects are we seeing in terms of that return to normal, given that the deputy governor said that we are in the normal range.
Mr Stevens—I think what you said, Ric, is that when you allowed for the changes in margins that the current setting was more equivalent to a cash rate that would in the past would have been a higher figure than we actually see.

Mr Battellino—That is right, yes.

Mr Stevens—The way I would characterise it is that I do not think we are in emergency anymore; I think we have done enough to lift off that. I would say that if you looked at the borrowing rates being actually paid on average by both business and housing borrowers, they are still below what I would call an average for the past decade or so; they are probably between 50 and 100 points below that average or something like that. So we are a fair bit closer to normal now than we were when we last met with you, given what we have done and what the banks added on top of that. When we eventually get to normal, there is a bit more work to do there but I think that is the order of magnitude we are talking about.

CHAIR—So we are talking about still a move in terms of interest rates going up between 50 and 100 basis points.

Mr Stevens—We are still below normal, I would say, which hitherto I think has been the appropriate place to be. But there is still a little distance to go yet before I think you could characterise the setting of interest rates as normal or average. Just not as much as by doing a calculation off the cash rate, that is all.

CHAIR—Yes. It was somewhat of a surprise for the market after your last meeting that the cash rate did not move.

Mr Stevens—I noticed that.

CHAIR—Are you able to give us a few more details as to your thoughts in keeping the cash rate where it was, given your last comments about still being some way away from the average or normal rate?

Mr Stevens—It is true, as you say, that there was some expectation. There was near unanimity amongst economists, at least by the day of the meeting. There had not been up until a couple of weeks leading up to the meeting. The market pricing on the day was I think maybe a 75 per cent chance of a move, so that was not unanimous. But I think if we went back to the bank’s language at the December statement, the minutes of that meeting and Ric’s speech, I do not think people would have—and they didn’t, when those communications came—taken it as a certainty that we were going to raise rates again in February. It was an open question. I think that was appropriate for us to leave it open. I think what happened was that during the holiday period some people read some of the incoming data a little differently to maybe the way we were going to read it, so they were a bit surprised. These things happen from time to time. But our reasoning, and it is set out in the minutes of the February meeting—which minutes have we just released? We have released February, right?

Mr Battellino—Yes.
Mr Stevens—I am losing track of time. The reasoning is fairly clear. It is that the board felt that having done three moves and seeing the banks add to that—so we have really had 3½ or, if you are a customer of Westpac, four—we were in front of the game enough that we have some scope to just have a little look at the initial effects of that on borrowing behaviour, the economy and so on. The full effects take a long time to come through. You cannot wait for all of that, but I felt—and I think the board agreed—that we had the scope to just spend that month to have a look at how things were travelling. I think that was the right thing to do. The whole point of starting early and promptly is that you get that luxury of occasions where you can wait a little bit later down the line. If you start late, you don’t have that luxury. So that is why it is almost always better to be reasonably prompt, particularly if you are starting at fairly extreme levels, which we were. That is the reasoning. As I say, it is all in the minutes—and I still think it was the right call.

CHAIR—So in terms of that reasoning and the comments you made today about the distinction between the cash rate and borrowing rates that banks are out there doing, I think you have made it pretty clear that you take into account the actual rates that are being borrowed out there in terms of the movements of the cash rate.

Mr Stevens—Yes, indeed. You see, the cash market is a very important market but it is a very special market. Not much borrowing actually goes on in that market—it is an interbank, overnight, professional market. Most of the borrowing by the end customers out in the country is not happening at the cash rate; it is happening at some sort of rate that banks set with reference to the bank bill rate or their funding costs and so on. So the effect that we are having on borrowers is actually through those borrowing rates. The cash rate is a way of moving those, but when there is a bit of slippage between the cash rate and those other rates we have to compensate for that to the extent that we can. We did that both the previous time we were tightening—we ended up doing less than we would have, I think, because those margins started to widen; when we came down, we went more than we might otherwise have done at the margin, because the spreads were tending to widen. We are still taking account of movements in those spreads. That is appropriate because it is those rates that people actually pay, or that savers are actually getting on their savings, that are actually doing the work.

CHAIR—Your statement gives a ‘confident but let’s not be complacent’ view of where we are in terms of leading into the recovery. Were the problems in Europe, particularly Greece and sovereign debt, also considerations in pausing?

Mr Stevens—At the margin they are. There is a bit of uncertainty about how all of that is going to be resolved. I do not think myself at this point that those issues will directly present a serious problem for Australia. After all, it is a sovereign debt issue for Europe. The issue they have got to deal with is a credible way of sorting this out and preserving European unity and sound finances and so on. Our sovereign position could not be more different, really. Maybe you could find one or two countries more removed from the sovereign risk issues than us. I cannot think of who they are at the moment, though. We are in such a different position. So I do not think that is directly going to affect our kind of sovereign issues. If it all went pear-shaped and affected the global recovery then that is something to watch. But at the moment I think that was a reason at the margin to be prepared to wait, if you had the luxury of waiting, which we did. There were other reasons to wait as well in February more to do with wanting to see a little bit
more information on the local economy. I think they are more important to us than the Greece story. But at the margin, the potential for turmoil from Greece is obviously there.

CHAIR—You have made the comparison in your answer just then between highlighting Australia’s position in terms of sovereign debts and saying that we are as far removed from that as you can think of in terms of another country as an example. You would agree with me, then, that the comments that Senator Joyce made were simply wrong in relation to his commentary on Australia’s position with sovereign debt?

Mr Stevens—I take it you refer to comments about default.

CHAIR—Yes.

Mr Stevens—There are few things less likely than Australia defaulting on its sovereign debt. There has never been a default by this country. I do not think there has been a default by any of the states, with one exception for one day, which the Commonwealth stepped in and fixed in 1931. There has never been an event of sovereign default by Australia as far as I know, and I very much doubt there ever will be.

CHAIR—So those comments from Senator Joyce were not helpful, were they?

Mr BRIGGS—You have put him in a very uncomfortable position here.

CHAIR—We will move on. I think it was Senator Joyce who probably put the governor in an uncomfortable position, to be fair. On page 35 of your paper Fifty years of monetary policy: what have we learned? you stated that there may well be attractions for fiscal authorities in committing to a path of relatively rapid fiscal consolidation, thereby allowing monetary policy to more accommodative than otherwise. How does this statement relate to Australian fiscal policy?

Mr Stevens—As would be clear from the wording at the bottom of page 1 and on the top of page 2 in bold, the paper is not intended to provide any particular message about current issues for monetary policy in Australia. So I was not intending to make any points about fiscal matters here. This paper is a 50-year perspective, is international in its perspective, and the point it is making in this section is that globally—and Australia would be included in this bit—everywhere we have seen much more active use of fiscal policy recently than we have for a long time. That is understandable and I think made sense in the circumstances that we faced.

It raises some issues as to how fiscal policy around the world will be conducted in the future. One of those is the timing of the consolidation. This is a very important question, less for us, really, than for Europe, the UK or the US. These are countries that have budget deficits of 10 and 12 per cent of GDP, and debt ratios of 80, 90, 100 per cent or more. They are going to have to get on a track back to sustainability. But, as I said at the beginning, they do not want to abort their recoveries in so doing, so there is a fiscal-monetary mix issue there. This is really just making that point. No particular message was intended for Australia here, as I think was clear in the disclaimer at the front of the paper—which most people who have reported on the paper have overlooked, I notice.
CHAIR—One person in particular. I refer to Mr Hockey’s comments in relation to trying to characterise your statements as commentary on the Australian situation. Clearly, from your answer, that is not the case.

Mr Stevens—It was a paper presented to a 50th anniversary symposium. It is about 50 years of monetary policy and then casting our eyes a decade into the future. That is what it is about.

Mr BRIGGS—But the link is there. There is a link between fiscal policy and excessive fiscal policy—that is, excessive government spending and interest rates.

Mr Stevens—in principle, that link is always there.

Mr BRIGGS—Exactly. Thank you.

CHAIR—The government is already undertaking what could be considered a relatively rapid fiscal consolidation. The MYEFO report shows that we are tightening in the order of one per cent of GDP per year. Is that consistent with the commentary you were making in relation to those issues?

Mr Stevens—Most of the improvement that is there is going to be a parameter variation, isn’t it? The economy is improving and that means that the automatic stabilisers that produce more revenue and less spending as growth picks up are working as they should. The thing for governments to do is to let that happen as it wants to occur. That is actually what is causing the relative improvement compared to the previous estimates, as far as I know, rather than new policies—although I might have missed something. But I think it is mainly that the economy is improving and helping the budget, which is a normal feature and something that we ought to welcome. I foreshadowed at an earlier meeting of this committee that I thought the likelihood was that we were not going to reach the debt peak that had been projected because things would turn out better. I think they are turning out better.

CHAIR—I have one final question. There has been some commentary about fiscal and monetary policy and how they have worked together or not worked together, depending on who is making the commentary. Do you care to make any comment in relation to the way in which they have operated since we last met, and more generally?

Mr Stevens—I think the general story when we met last time was that it was understood that, once the job has been done, both arms of policy have to move in the direction of withdrawing stimulus. We have begun our withdrawal. I think it is still our assessment that the peak effect of the budgetary measures on the growth rate of demand was in the middle of last year. Its peak effect on the level of demand is about now. If things run to time—and it is important that they do—it should tail off over the year ahead. So I do not think I have anything new to say about that. For both arms of policy I suppose we have to keep re-evaluating the outlook for the economy and amending our trajectory—in our case, anyway, it is easy to amend. It is not as easy to do with fiscal policy but, if necessary, we can amend the pace at which we withdraw our stimulus as views about the outlook shift to views that are somewhat more optimistic now than they were in August.
**Mr BRIGGS**—Just on a slightly different track: On 2 November last year there was an article on the *Lateline Business* program about suggestions that the Reserve Bank executive selectively leaks the likely outcome of the board meeting prior to the board meeting. I guess the presenter summarised it best:

Certainly, there’s disquiet among market economists that the Reserve Bank is selectively briefing certain journalists in the lead-up to rate decisions. Many argue the practice undermines the board process.

I am just interested—did you see the report, and do you have a comment?

**Mr Stevens**—I did see the report. Apparently there were not too many selective leaks in February, because everybody was surprised, so I am not sure what to make of all this.

**Mr BRIGGS**—So, you—

**Mr Stevens**—No, people do not leak the outcome. For a start, the staff do not take calls from the media after the relevant internal meetings where we have come to the view of what we are going to recommend. That is usually on the Thursday morning; the papers go that night. Secondly, we cannot be certain that the board will do what we recommend. It is a board of nine people, and I can assure you they are all of independent mind. People do not leak that information; in my experience the Reserve Bank never has leaked and, if I can help it, it never will.

**Mr BRIGGS**—I presume you looked internally after the program to assure yourself that—

**Mr Stevens**—I am quite confident that the processes we have are quite robust.

**Mr BRIGGS**—Thank you. In the 9 February paper that we have discussed already—the symposium—you discussed the issue, as you did last time before this committee, about so called ‘leaning into the wind’ or asset price targeting. How developed is your thinking and the bank’s thinking on that issue?

**Mr Stevens**—There is a big difference between ‘leaning into’ and targeting asset prices. I do not actually favour—at this point in time, anyway—having an asset price target. Which asset price would you be talking about, for a start? There are many assets. But I do not favour having a target. If we put this in historical perspective, which is what the paper tries to do, there have been two views. This debate has been going ever since the Japan bubble period, and that is not far short of 20 years. One view is that you should lean into these asset booms, and I might say that it really is not the asset price per se, so much as the leverage.

If we have an asset price boom in old masters paintings and a few rich people speculate there and some of them lose money—but it is not borrowed money—so be it. If it is houses, and half the population is doing it, they are all geared up then a housing price collapse renders banks insolvent, then that is a very different proposition. So it is the leverage that really matters. The lean into the wind view is that these dynamics are sufficiently dangerous that you ought to be prepared to lean on them, even a bit, and use all the tools that you have got at your disposal, which would include interest rates but not be limited to that—there would be other tools. The

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idea of that is that even if that slows growth for a little while that is probably better than having a major crash in three, four or five years time. That is one view.

The other view is the clean-up-after view. That view is that the dynamics of these things are so unstable, it is so hard to pick whether it is a bubble et cetera, the best thing to do is to just not worry too much about them, respond to the normal things you respond to and if there is a bust then you ease aggressively to help the economy. That was the Greenspan-Fed view. One difficulty that that view has encountered, I think, is that the mess proved to be so big that conventional tools have found it pretty hard to clean up on this occasion. So I think the weight of opinion is tending to shift a bit.

If you think of there being a spectrum from ignore them to every time you see an asset price move that might possibly perhaps be a bubble, run out and hit it with a hammer—if there is a spectrum there, my guess is that opinion is shifting a bit in the direction of being more active without going all the way to total aggression. I personally think that that is the likely outcome as people evaluate this episode as they look back. Phil, you have worked on this a lot. Is there anything you want to add?

Dr Lowe—I think it is important that people do not think of this as the central bank targeting asset prices or pricking asset price bubbles, because I do not think anyone thinks that is sensible. The issue is really: if you are seeing imbalances develop in the financial system, what should monetary policy and regulatory policy do? As the governor said, I think the weight of opinion is shifting towards the view that both regulatory and monetary policy need to do something.

These financial imbalances arise if credit is growing very quickly, if asset prices are growing very quickly and you have got a lot of innovation and competition and new things happening in the financial system. That particular cocktail leads to risk building up, and I think there is a strong case for the central banks and the regulators to take note of that and not just stand by and allow the imbalances to build up and then ultimately correct. But it is not about targeting asset prices; it is not about pricking bubbles. It is about responding to financial developments in a sensible way.

Mr Stevens—Some people are presenting this as the failure of inflation targeting, that targeting CPI inflation was all a big mistake because all these asset prices got out of whack and that has all brought us undone. Possibly in some countries that might be the story, but in our case our inflation targeting system has always had sufficient flexibility to (a) take account of the business cycle economic activity in a reasonable way and (b) at least make sure that we were not unduly, with a very easy monetary policy setting, fostering a rapid growth of credit and asset prices.

Many people quote the episode in 2003 where the Reserve Bank tightened monetary policy, said a lot about housing prices which were escalating quickly at that time, people were becoming very buoyant, and Ian Macfarlane had a lot of what we have called open-mouth operations, saying, ‘You’ve got to calm down.’ There were a couple of quick rate rises, which would have needed to be done anyway under the inflation target but we possibly did them a little earlier than was absolutely necessary. But that episode I think successfully helped to just calm down, at least for a while, a housing market that was getting a bit overheated.
So we have always felt there is an amount of flexibility we have to take account of these things in a sensible way without throwing away our main framework—and I think that is the thing to preserve. The framework we have got is good. We do not want to throw that out. We just do not want to let a very narrow-minded, mechanical interpretation of it blind us to the potential for these other imbalances to develop which will bring us undone later on. That would be our view.

Mr BRIGGS—On the 1996 statement which gives you your independence, I noticed in Paul Kelly’s book there was a reference on page 117 to in 1994 the then Prime Minister influencing a decision of the bank, which of course does not happen anymore, post the 1996 statement. Would you consider that that statement would need to be altered with the government if you wanted to change the way or increase the focus you put on these issues?

Mr Stevens—I am not writing to the Treasurer saying, ‘We’ve got to reword this thing.’ I do not really feel exercised about that. These things will be rethought next time there is a new government or a new governor and it will be for those people at the time to decide whether there are some words about this. I do not feel, myself, that we need a wholesale rewrite of that at all. We are on the third version of that statement now—last issued in 2007. It is in operation for the term of this government or my term, whichever ends first. It has been going for more than a decade. The inflation targeting framework itself has been going for 16 years. I think this system is working pretty well. In my view we do not need any kind of major surgery here. What we should always be doing is watching the evolution of knowledge and experience and integrating that into the way we conduct ourselves within the framework, but I think the framework gives us adequate scope to do that.

Mr BRIGGS—Yesterday, Dr Lowe made some comments in relation to labour market flexibility and we have discussed labour market flexibility at each of these hearings—

CHAIR—You have.

Mr BRIGGS—or each time I have been part of them at least and before that. Noticeably, the Labor members do not discuss it. I noticed today in your statement you identify again the importance of flexibility in the labour market. There is a story in today’s Daily Telegraph about Japanese business leaders warning:

... that a fresh wave of union militancy threatens billion-dollar investments in the country.

At the last hearing we discussed risks about the supply chain from Western Australia and so forth. Over the last three or four months there have been, Workplace Express has reported, at least nine workplace disputes reported and Paddy Crumlin, the head of the MUA—one of Craig’s friends—has commented that anyone who thinks that productivity increases need to be attached to wage increases is a dinosaur. Are you concerned about the direction of the labour market?

Mr Stevens—One would have to observe, I guess, that in that sector those who represent the workforce are operating in a pretty strong environment right now and I guess they are seeking to use that, which is their job. I am not sure what more to say about IR issues than I have said before. Flexibility is important. We have seen that in recent years, both in the boom—I think we
got through that much better, incomparably better than we would have 30 years earlier or with 30-year-earlier structures—and in the downswing with the way the flexibility in the system has enabled employers to keep people on payrolls at reduced hours, all those sorts of things. Flexibility is very important. The test is going to be how the new arrangements are basically administered and implemented by all the parties involved, which will be the employers, the unions, the Fair Work organisation and so on. It is extremely important that all this be done sensibly and flexibility is as key now as ever. For us to get the most value as a nation out of the opportunities that the growth of Asia into the future presents, we want to retain that flexibility. There is no question about that. It is hard to me to judge how serious the problems are because I am not in those firms. I can only record that a lot of business people are expressing concern at the moment.

Mr BRIGGS—Previously you have expressed before this committee and elsewhere that wage increases need to be attached to productivity increases. If it increasingly becomes a problem that there are wage increases outside of genuine productivity increases, that the system of bargaining which has operated for 15 years starts to fall down again, will that pose increased pressures for interest rates?

Mr Stevens—A rise in unit labour costs is going to push up prices. All other things being equal, we will respond to that, if it is coming, but the long run implication of excessive wage pressure is unemployment. The central bank’s job is to make inflation at the target. Industrial relations arrangements in the end will determine what rate of unemployment coexists with that.

CHAIR—In making the point about unemployment in your opening statement you made a statement about the existing flexibility in the labour market, including the ability of firms and employees to adjust hours as being a contributing factor to limiting the effect of the global financial crisis on unemployment.

Mr Stevens—It has been, but of course the new arrangements are just coming in. So the test is whether the flexibility is retained. I am not saying it will not be. I cannot judge, but the question being asked is whether that is a potential risk. As I say, it is important to retain flexibility and it is very important that all the parties involved do that.

CHAIR—You have also made comments in the past that—I think during the first hearing of this government—about the need, in your view, for the government to balance fairness, being a consideration in relation to industrial relations.

Mr Stevens—in our community, people think fairness is important and what I have said is that, to the extent that there is a need to balance fairness and efficiency in other considerations, that is your job in the parliament. It is your prerogative to do that.

CHAIR—Before I go to Ms Jackson, I will just say that I think Paddy Crumlin is a very good union official, but we have very rarely held any economic views which are in common.

Ms JACKSON—I would like to talk about bank funding. I think you would agree with me that there have been suggestions from the banks that one of the reasons their own rates have moved in the way they have is the cost of bank funding. I note there is some updating of prudential standards which may require banks to hold greater deposits or higher proportions of
capital and other liquid assets. We are also told that the Bank for International Settlements recently talked about requiring or issuing proposals to strengthen global capital. I think it is fair to say that the Australian banks are concerned about the implications for this on the cost of bank funding. I am curious about the RBA’s view on the regulations, the prudential standards as well as the possible global requirements for promoting—I think they are promoting or they intend to promote—a more resilient banking sector. I say that in the context that I still understand the Australian banking sector can hold its head very high—particularly through the global financial crisis.

Mr Stevens—Let me take that in two parts. I will say a little bit about the regulatory issues and I might get Ric to talk about what is happening to funding costs and what our analysis is showing there. We are going to publish something on this fairly soon. On the international regulatory side, there is a very big push emanating from the G20, among other places, for stronger standards to make banks safer. The targeted banks when they are thinking of this is the 30 or 40 globally active, very big institutions which took more risk than they should have given the capital they had, got into serious trouble and therefore placed immense strains on their home economies, on the global financial system and in some cases required a considerable amount of taxpayers’ money in their own country to rectify the situation. So we are talking about big globally active banks in the US, Europe, UK, Switzerland—a few countries like this.

The engine room of banking supervision standards globally is the Basel Committee on Banking Supervision. It is not actually the BIS; it is just a committee that BIS supports, but it meets in Basel. The outcome of that is likely to be tougher capital requirements, particularly on trading book assets—the securities the banks trade for their own purposes; and tougher standards on liquidity. There is talk of maybe even tougher again for banks that are regarded as ‘too big to fail’. Then there are various regulatory initiatives at a national level—some out of the US, some out of the UK—about prohibitions on certain things we can and cannot do.

What I have said publicly is that we want to be sure that in addressing the egregious problems that these 30 or 40 large institutions created we do not unnecessarily and inadvertently impair the thousands of other banks in the world who have been okay. Not that we should not change standards and lift them at all; we will—it is inevitable after an episode like this that the standards are going to require tougher conditions on capital and so on. But this needs to be calibrated in a way that helps make the system more resilient to the next crisis—and one day there will be one—but does not impair our capacity to get out of this one. The next crisis is not soon, I don’t think—it is some time off—so we have time to get this right. So my point is to do this very carefully and not rush through any sort of half-thought set of proposals.

The local banks here are quite exercised about the liquidity standards in particular. One reason for that is that, as initially drafted, these standards require much higher holdings of government securities, because they are very safe. On the standards literally interpreted, there are not enough government securities in this country for the banks to hold, which actually goes to the debt issue—there isn’t very much government debt here. So that standard obviously is not feasible, literally, here. I think some reasonable arrangement can be made with sensibly drafted standards with a reasonable degree of national flexibility that will be able to have an arrangement for banks here that addresses the fundamental issue of needing to manage liquidity carefully but does not give us a silly rule that cannot be met. This is really APRA’s job, not ours. We are
interested party and we have discussions with them and with the banks about it, but in the end it is an APRA responsibility. I would be pretty confident that that will work out okay.

But, on the broader international thing, my point is that it is very important that all the proposals that are on the table can be very carefully analysed by the experts. With great respect to the political process, it has to allow time for that to happen and not press too hard for deliverables at meetings too quickly. There is a work stream called the Quantitative Impact Study that all the Basel committee countries—and we are one—go through, where you very carefully analyse what the quantitative impacts of the proposals are and how they add up. It is very important that that work be done carefully and systematically and that the time be allowed for it to take place so that the new rules can be appropriately calibrated. We do not want to, in our efforts to ensure we never have this crisis again, actually give ourselves a different problem. That is important. I have said a lot there. Ric, would you be able to talk about the funding cost issue? What is happening here?

Mr Battellino—Sure. The general point is that, the more capital and the more liquidity you force banks to hold, the more it will push up the interest rates that they have to charge borrowers, because they have to make up that extra cost somewhere else. As Glenn said, there are initiatives around the world at the moment looking at those issues, but they are still being calibrated, so we do not really know what the impact is going to be.

The other thing that is going on at the moment is that there has been a general tendency for supervisors and rating agencies to try and encourage banks to move more and more of their funding to deposits and long-term debt. The banks have responded to that by bidding much more aggressively for those things, and we have already seen the impact of that here, particularly bidding for deposits. Over the long run of history, banks on average probably used to pay about 150 basis points less than the cash rate for deposits. Now, because they feel under pressure to increase the share of their funding that is coming from deposits, the interest rate they are paying there, on average, is equal to the cash rate and, as you know, for some special term deposits you can get interest rates of over six per cent, which is well above the cash rate. So this is adding to the cost of funds.

So there has been a movement of competition for the banks. Through the period when credit was easy, banks were competing very aggressively on interest rates on loans. Now the competition has shifted very much to competition for deposits, because that is the binding constraint on banks’ balance sheets. So that is where the competition is at the moment, and it is really pushing up the cost of funds to the banks. As I say, once the Basel committee and the Financial Stability Board determine these other rules on capital and liquidity, there could be further implications from that if they are very strict rules. So these are all things that are going to impact in the period ahead.

Ms JACKSON—And these are the things that you factored into your considerations? What you are saying is that potentially we are facing a substantially longer term higher cost of bank funding for some time to come.

Mr Stevens—These are medium-term things—the Basel rules will not come in for a couple of years—but we have certainly been factoring in the observed funding cost increases because of
this deposit competition and so on. That is actually happening now, as opposed to in the future, and I think we have been factoring that in, and we will need to continue to do so, I suspect.

Ms JACKSON—In addition to the deposit competition, it is also about accessing funds from overseas and the costs they are paying for accessing those funds?

Mr Battellino—That is right, yes, because there has also been a premium on banks borrowing longer term, and for some of that longer term money they have to go to overseas markets, where the cost is quite high.

Ms JACKSON—So we are still likely to see for some time some pressures on credit availability?

Mr Stevens—At the moment we are still seeing some elevated costs—relative to the cash rate—for some of the sources of banks’ funding. What has actually happened to date is a complicated story. In our forthcoming bulletin, which is coming out in March, we are going to publish an update of a piece that we had a while back on what is actually happening to funding costs and margins. The story had been that initially net margins were squeezed in the first part of the crisis, then that was recovered as banks raised their loan rates relative to funding costs. We are going to give the next instalment on that, which I think will bring us up to late last year, in this forthcoming piece. It aims to give everyone a framework because in this whole debate about funding costs everybody talks different languages and it gets very confusing. So we are trying to say, ‘Here is a framework with a common language, and you can all drop your own assumptions in and go from there. But at least we are in the same framework.’

The broader sweep of things that we were talking about were these possible regulatory changes. We went through many years where the cost of credit was cheap, where competition around the world—including here—was aggressive, where risk margins got bid down, where funding for banks to do all this was easy and inexpensive and banks—not our banks, but some of the really big international banks—actually did not have enough capital for the risks they were really running. That meant the cost of intermediation was cheap, and so a lot of it was used. I think that for a while we are going to be in an era where that is not true anymore; where the cost of intermediation is going to be higher than it was because regulators will insist that you have to have the amount of capital needed for the risk that you are taking, where capital market investors are more wary of extending cheap credit to entities and so on. That is a kind of shift of an era.

Ms JACKSON—And not necessarily a bad thing. It is—

Mr Stevens—It is a good thing for stability because less risk ends up getting taken—at least for a while. Eventually the clever people are going to find out ways to take them anyway. But that will take a while, and for some time less risk generally is going to be taken and, for the global community who use the intermediation services of the financial system, the cost of that service, which is really measured by the spread between what they borrow at and what they lend at, is going to be a bit higher than it used to be. I cannot see how that is really going to be avoided.
Ms JACKSON—A final question on a slightly different tack is about house prices. You talk about how there has been growth—I think even in your statement it says ‘smart growth’ of 13 per cent?

Mr Stevens—Yes.

Ms JACKSON—I wonder if you are not concerned that this kind of rate of growth—

Mr Stevens—I think it would be concerning if it continues. It is quite strong, but in seeking to think about what it means, we have got to be conscious of a few things. Firstly, the rate of growth of housing credit behind that is about eight per cent. That is quite healthy; I would not regard that as grossly excessive—it used to be 18. One of the real worry points you are looking for is rapidly rising asset values, very strong growth in credit and declining lending standards. What we have is pretty strong growth in house prices over the past year—I will come back to a nuance there in a moment—but credit growth is not too bad; it is moderate. Lending standards for households are actually increasing, not falling. Banks are tending to reduce loan-to-value ratios—you have got to have a bigger deposit and so on, and I do not think you can get a no deposit loan now et cetera. I welcome that; I think that is a very good thing. We may well see more of that if house prices continue to escalate because the banks own risk management will tell them, ‘Be careful here, and maybe be a bit tougher on the standards.’ That is what they should do.

So we do not see incredibly fast growth in credit at the moment—we might, but at the present time we do not—and we do not see lending standards falling, we see them rising. They possibly need to rise more, I am not sure, but at least they are moving in the right direction. The other thing to say is—it is only tentative—but to my eye, the prices at the bottom end of the distribution—the cheaper end—have actually flattened off a bit over the past few months. Is that a fair call, Phil?

Dr Lowe—Yes.

Mr Stevens—Interest rates have risen. In terms of first home buyers, the boost is now fading and they are coming way back as a share of approvals. So at the bottom end, at least at the moment, the prices may have stopped rising. That is tentative and it might not persist, but it is not necessarily just pure blue sky right across the board. At the top end it is very strong, still. That end, I think, suffered a fair bit in the crisis. Bankers, corporate people and people who had a leveraged lifestyle, all had to pull their horns in. Now they are feeling relieved that they lived and they are more confident. So that is a dynamic; it is something to watch. Those are at least some perspectives on this issue.

Ms JACKSON—Thank you.

CHAIR—We have a follow-up question from Mr Turnour but we will probably take that after the recess break. We will go now, instead, to our school students who are here. William Barker from Canberra Grammar School has a question for you.

William Barker—Mr Stephens, what do you believe is the best policy in controlling asset price inflation and consequent over-leveraging—monetary policy or regulatory policy?
Mr Stevens—Both, I think. It is a good question, William—a very topical one—and I think the lessons that I would draw from what we have observed around the world is that regulatory policy needed to do more in containing risk taking by intermediaries. This is why we are having a discussion now, very actively internationally, about so-called macro prudential tools—by which, people mean tools which bank supervisors have, such as capital ratios, loan-to-value ratios and things like those—and using those to cap the upswing in credit and asset markets. But, as we were discussing earlier, I think another lesson is that if you run along with very low interest rates—even if that might seem justified by inflation and so on—and you see a big rise in leverage, falling lending standards and rising asset values, you probably ought to have interest rates a bit higher.

I do not feel very confident that, if interest rates were in the wrong place, regulatory tools alone would be enough to contain them. I think we have evidence in Australia’s history that that does not work. So I think the simple answer to your question is that I suspect in a really big episode you may have to contemplate both.

CHAIR—We now have Lillian Zsigoszki, from East Hill Girls Technology High School.

Lillian Zsigoszki—Mr Stevens, as monetary policy is generally regarded as a blunt quantitative instrument, meaning implementation affects the entire economy, how can monetary policy target individual sectors to implement Reserve Bank objectives?

Mr Stevens—It cannot target particular sectors very well at all. It is, as you say, Lillian, a policy which affects the overall economy. But our objective is an overall economy objective. Our objective is to keep inflation steady and, subject to that being achieved, to try to keep the aggregate economy close to its potential path. So we are not trying to tweak specific sectors. The difficulties arise when one particular sector is doing much of the driving and is pushing the overall economy off course. Of course, when we respond to that, that sector will probably still be too strong and the other sectors will be a bit weaker than otherwise but all we can do is make policy for the average. That is all we have ever claimed we can do. So in that sense it is a very general instrument. You called it a ‘blunt instrument’; in a sense it is. Most economic policy instruments are actually fairly blunt, when you come down to it. I am not sure there are all that many sharp ones.

Proceedings suspended from 10.44 am to 11.01 am

CHAIR—We will recommence this hearing. Governor, Mr Turnour has a follow-up question to the line of questioning that you were getting from Ms Jackson.

Mr TURNOUR—There is a lot of discussion around increased funding costs and the impacts of the global financial crisis. Mortgage holders in the community want to know, prior to the global financial crisis, what was the spread in terms of bank interest rates and the RBA’s cash rate and what is it now? Of the increase above the cash rate that we have seen, what proportion is related to increases in funding costs and what proportion is related to the fact that there is less competition in the banking sector? Are there real risks at the moment, in that banks are able to extract larger profits than they should because of a lack of competition as a result of the second tier lenders disappearing through the global financial crisis?
Mr Stevens—The pressures on funding costs and the disappearance of the second tier lenders are the same thing. You cannot take those apart because those sorts of lenders relied more on wholesale funding and securitisation than the major banks did. That business model is fundamentally much less profitable, if profitable at all, in the environment that we now see. So I do not know that you can apportion these things. Ric, can you say what the spreads were pre and post?

Mr Battellino—Funding costs have probably risen by a bit over a hundred basis points relative to the cash rate since the pre-crisis period. To give the history, if you go back about 10 years, the margins that banks charged are the difference between their funding cost and their average interest rate on loans. The margin used to be about 3¼ per cent, and then over a decade or so of competition—that is, up to just before the crisis—that margin came down to about 2¼ per cent. So there was a hundred-basis-point squeeze in banks’ margins over about a decade. Through the crisis period that margin widened out to a little bit under 2½ per cent, so there has been about a 20- or 30-point widening in banks’ margins. This is the difference between the average rate they receive on loans and the rate they pay on funding. We are starting to see that margin contract a little bit now. As we go forward we might well see that interest margin level out and even come down a little bit, and I think we are seeing some early signs of that. The big story is the difference between the cash rate and the funding costs, which is where the big movements have been. There has also been a marginal movement of about 20 or 30 points in the difference between what the banks are paying on deposits and what they are receiving on loans.

CHAIR—Mr Billson, I would like to formally welcome you to your first hearing.

Mr BILLSON—I am feeling the love, thanks. Governor, I would like to talk about inflationary pressures. We touched briefly on the concern in the business community about wage pressures without commensurate productivity gains. We have seen some very prominent examples of that. We have been outside the core inflation band of two to three per cent for 2½ years. We are now seeing the IMF saying that maybe four per cent is the mark. I wonder whether that falls under the definition of an economist who sees something in practice and wonders if it works in theory—the practice has been higher than that core rate, so why not adjust the targets? Also, there has been a lot of pressure on household budgets with cost of living increases. That paints an inflationary expectation fear in my mind. I am wondering what you are observing and what you see into the future.

Mr Stevens—It is true, as I said in my opening remarks, that inflation rose to be clearly excessive in 2007, which was why we were lifting rates. It peaked in about the June or September quarter of 2008, if I remember rightly. The latest figures for the CPI have actually been below the target, until recently. I think the latest number is 2.1 over the year, so it is at the bottom of the target zone. That is being held down by some things that happened a year earlier—petrol prices fell and so on—so it is probably not a good gauge of the ongoing inflation rate. We would look at the various core measures, which we compute a whole lot of. They are coming down. In the last year, 3¼ per cent on underlying measures was our take. In the last six months it was a bit under three per cent. In the last three months, if you annualise that, it was about 2½ per cent, which is right where we want to be. That is what we expected would occur, given that the economy slowed, we built up a bit of spare capacity, wage growth fell quite sharply last year and the exchange rate went up—
Mr BILLSON—There is that catch-up mood around in wage claims.

Mr Stevens—Yes. I think there probably is going to be some intention to catch up. We are factoring some of that into our forward-looking assessment. That is why we think inflation is not going to keep falling. Nine months ago we would have said inflation was going to keep falling to maybe 1½ per cent. Now the low point is 2½ per cent and we think that probably, if economy works out in the way we expect it to, it will start to drift higher from there. That is why we are talking about the fact that we will probably need to tighten further, if things work out as we expect them to. Expectations of inflation I think are okay at the moment. The various measures we take from bond yields or from a consumer survey that is done are kind of where they have been over the 15 or 20 years that we have had low inflation, so I think they are reasonably well anchored at this time. That is, though, something that of course we watch very carefully. The high currency is helping us, and that will continue to flow through over the coming year because that mechanism takes quite a while to fully work its way through.

But the thing for us to be watching is how quick the pick-up in demand is, relative to available capacity. As I said at the beginning, we have some spare capacity generally in the economy but a fair bit less than you would normally get if you had a serious recession. It is good that we do not have a lot of spare capacity. You do not want to have a lot. But, equally, you want to be watching the pace of demand for growth when you do not have much because you are wary of the potential for inflation. That is why we are in this period of moving off the emergency rates. Over the period ahead, if things pan out as we expect, we are likely to be continuing our way back to more normal settings.

Mr BILLSON—You touched in your remarks and in the February governor’s statement on things improving for big business. I am particularly concerned about the difficult financing environment for small businesses, the reduction in competition from the government’s bank guarantee doing over an important source of competition for small business financing, the margins that are being asked of them, the restrictive terms and conditions and the fact that four out of five in that PricewaterhouseCoopers survey said a lack of access to funding is going to impede their achievement of targets this year. What is your take on that? Also, the NAB just last week said that some of our domestic rules about capital charges actually skew lending very much towards mortgage lending. I think the quote was that you can do ‘up to five times more mortgage lending relative to business lending in terms of capital management’ even if the same home is the security.

Mr Stevens—I think it is an economic fact that lending for mortgages has historically been far safer than for other things. That is why the Basel process downweights the weighting on mortgages when you are calculating the capital charges. Certain mortgages in America, of course, proved to be much more risky than had been assumed. But, leaving that aside, in this country certainly it has been and remains a very safe form of lending. It is true that for a dollar of capital if you are just earning the same returns you can do more on housing. This is why you charge more for business loans. This is why the business loan has a risk margin built in which is considerably higher than a risk margin on a housing loan, so the banks compensate for that in the pricing.

In terms of competition, there is a lot of focus, as we have heard in some of the earlier questions, on competition in the mortgage market. I do not actually think that is Australia’s
problem. I think we are going to have plenty of finance for housing because it is relatively safe and it is pretty easy to do. There is probably not quite as much competition at the margin as there was in that space, but some of the competition that was there was actually doing lending that I think really should not have been done. I do not think we are going to have a big problem there.

The problem is more likely to be, as you say, for small business. I am often asked what can be done about that and I always have to say I do not have a policy silver bullet that would fix that. What I would say, though, is that in our liaison, which admittedly is for medium and larger firms more than lots and lots of really small firms—we do have some engagement with small firms, but not as often—what we are hearing is that the proportion of respondents that are saying credit is getting tougher to get has gone down. Some of them are saying actually things are getting a little bit easier.

We are hearing some reports now of some risk margins on larger firms starting to come down. I think that will follow to the medium and smaller ones over time. The reason I think it will is that I think banks were being cautious, understandably, but probably a little more cautious than they might have needed to be, given the fears about how the economy would be very weak. They, like everyone else, have been pleasantly surprised that the provisions they are having to make for bad loans are not as high as they felt. Their balance sheets are not growing because a lot of businesses are seeking not to have debt, to economise, raise other funds or get their leverage down in some way. I think the banks are finding that the balance sheets will not grow, and they are not going to be as profitable as they want to be in that world.

So I think over the next year we will likely find that conditions for a range of businesses will get a little bit easier. They will not go back though, if you think back several years, to where you had pretty easy credit conditions everywhere in the world, we had foreign banks in here aggressively competing and so on. That is not going to return in the near term. I do not think we will go back to that world, but we probably will see credit conditions not quite as hard as they are now in a year’s time. That is the best I can offer you.

Mr BILLSON—There is still a spread of $2.5 to three per cent for a borrower. It might be the same person with the same bank for the same sum of money with the same security—their home and their firstborn, which is increasingly being asked of small businesses—and there is still a big spread, and this is causing great grief. Putting that to one side—

Mr Stevens—But the thing is that the spread, too, of course is lower than it used to be.

Mr BILLSON—The housing price bubble in Melbourne, in parts of Sydney and in Brisbane, according to national valuation firms, is being exacerbated by the relaxation of foreign investment requirements. We are seeing a lot of foreign money coming in and buying selective properties; that is having a vacuum effect to suck up the prices right across the market. If you are inclined to lean against the wind—and it may be an offshore breeze—have you picked up that concern that that is starting to really be an influence on house pricing and house price inflation in some of our capital cities, and is there a need for policy action on that front?

Mr Stevens—One certainly hears reports of considerable sums of foreign money around. Is that able to go into the established market, though?
Mr BILLSON—Yes, it is now.

Mr Stevens—It is?

Mr BILLSON—It is a government policy change.

Mr Stevens—I think that dimension of housing prices is a global phenomenon too, which would mean, of course, that when we think about what we do about it here we would have to keep in mind that, if it is global, we probably cannot stop it that easily, at least not without more insulation between us and the global system. Everywhere in the world, desirable property locations are seeing prices pretty high. In fact, it is a feature that, while property prices have fallen in the countries that have had the worst crisis, even in the UK they are starting to rise again now. In a range of other countries that cut their monetary policy aggressively to counter the downturn, if their banking system was not impaired, a lot of them have seen house prices rise as a result. We are one of those, but there are a whole bunch of them in Asia. So it is an issue not just for us.

Of course, that money, if it is foreign money, is not borrowed here, so even so-called macroprudential tools that we might use or that APRA might deploy would not make any difference either. So it is important to keep that in mind. I do not have a sense of how quantitatively prevalent that is relative to the local buyers, but I suppose it is one potential part of the explanation for how you have quite high price rises in some top-end areas but overall domestic housing credit growth is reasonably steady. It is part of the picture.

Mr BILLSON—I am happy to keep going.

CHAIR—Yes, keep going.

Mr BILLSON—This is an unusual invitation—to keep going. We have heard that domestic banks are quite exercised by some of the Basel discussion around capital adequacy and the like given that a lot of liquidity is held as other bank paper, and there is a push against that to hold bonds as you have discussed. That sounds like a very North Atlantic solution to a problem that does not exist here. How vigorous are you and your colleagues in those international fora, and how vigorous does the government need to be, to make sure we do not get fitted up to a solution to a problem that is very North Atlantic that could gum up finance in Australia for quite a long period of time?

Mr Stevens—We have made our points known, and APRA puts these points, about the liquidity rules—in particular through their membership of the Basel committee, as do we. What we need here is to just make sure that there is a certain amount of national discretion, which there always is in these capital rules. That is why Basel II took 20 years to negotiate. So we need to do that, which is why I say that it is imperative that these proposed standards be very carefully quantitatively assessed; that should be thoroughly done, with time to negotiate sensible flexibility for countries like us.

It is a very good phrase: the whole crisis actually was very much a North Atlantic crisis. It was really only a global crisis for six or eight weeks, I think. The rest of it is mainly a North Atlantic story. There is a problem with liquidity and the problem was that institutions relied on the
assumption that wholesale markets would always be open at a reasonable price and they just were not open, and those people came into serious problems. So there does need to be, I think, a genuine effort on the part of financial institutions to think more about liquidity risk.

One criticism of the Basel process perhaps is that for 20 years it was fixated on capital. Capital is important but, it did not maybe spend enough time thinking about liquidity risk, and that is now to be rectified. That does have to be done but it needs to be done in a way that is sensible. We could go on, but the main point is that we do need to make sure that as far as we can there is adequate national flexibility. We are saying that. The work at the technical level needs to be allowed time so that this is all done sensibly.

Mr BILLSON—One last question, if I may. The concentration of market power in the big banks, the demise or let us say suboptimal time the smaller banks and non-bank lenders have had of late, the impact of the government’s bank guarantee, what do you see as the state of competition in Australia? Are you satisfied at the robustness of it or are there actions we could take to improve competition in banking?

Mr Stevens—I am not sure I accept, to begin with, that the guarantee per se did all that much to change competition. I think the environment changed the competitive position of those institutions. It is true that they did not like the fact that the pricing had a risk tiering in it. I am the one who wrote down the prices, so they can blame me for that—

Mr BILLSON—They do.

Mr Stevens—Not to my face, I might say! I think it was appropriate to have risk based pricing, incidentally. Whether we got the numbers exactly right obviously opinions can differ, but it is appropriate to have risk-based pricing. But the guarantee is phasing out now, so that is not going to be an issue. I think in an environment where suddenly everywhere in the world there is a flight to safety you are bound to see—it is human nature—that bigger institutions are going to look safer to people. Whether they actually are safer or not they are going to look that way, and we did see some of that. I actually think the system coped with that fairly well, by the way. I think through sensible behaviour on everybody’s part we got through that flight to safety and came through pretty well. Competition is reduced in certain segments. As Ric said, it has not disappeared, it has been relocated. There is now intense competition on the liabilities side of the banks’ balance sheet because of the environment we are in, and a new sort of person is benefiting from that competition, people who have not benefited all that much over the years, namely savers. When we think about competition we often worry about housing borrowers, fair enough; or business borrowers, fair enough; but what about the savers? We should not forget them, and they are actually benefiting from the competition that is in place on the other side of the balance sheet at the moment.

In the future, I think we could expect that securitisation—it is gradually improving—will return as a funding source, but not in the same size. A lot of the buyers of the securitised mortgages, I think, Ric, were offshore—the sieves and conduits and so on—and they are not going to come back. So the size of those flows will not be what it was, but it will recover some way and it will be, I think, again a viable and useful form of funding and, at the margin, a form of competition, keeping the lid on mortgage costs. So for small business it is much harder because you cannot securitise it; they are more idiosyncratic products—they are not
homogeneous—so the bankers have to know the customer. And more resources are involved in doing that, so it is harder to generate competition through these market mechanisms. The best I can do, as I said before, is that I think things are likely to get better as the year progresses because the banks will be keener to do it.

**Mr FITZGIBBON**—Governor, I will only ask two quick questions, to ensure that everybody is provided with an opportunity. Thankfully, Mr Billson beat me to the punch on the first one, about Basel. But I just want to add to that: I am also concerned that we might be forced inevitably to take medicine we do not need here in Australia. You have answered the question very effectively, but can I just ask whether anything Olivier Blanchard had to say in his paper gives you additional concern, given that he is already being accused of laying the path, if you like, for the Americans to run a higher inflation rate. It could be argued that—

**Mr Stevens**—Do you mean his comments about inflation targets?

**Mr FITZGIBBON**—Inflation targets and, in particular, the shift to a heavier regulatory environment which arguably has the potential to be overdone with respect to our own situation here in Australia.

**Mr Stevens**—There is a very strong line of thought in the major countries that we have just got to have stronger regulation, and I think that is understandable because, to be perfectly frank, there were regulatory failures in these cases. But this is where perspective is needed, of course. We were operating under Basel, along with everybody else, but we did not have a problem. Some of that is luck but some of it is that we actually had an effective supervisor who did their job. I think even the supervisory community in the US and the UK and some other places would concede that there were supervisory practice failures there. So it is not a matter of just having the rules—you have got to enforce them properly.

On inflation targets: I do not agree at all with what the IMF paper said there. The basis for the argument that maybe you need a higher average inflation rate is so you can then have higher average interest rates, and that means you could cut them more in an emergency, and the reason they think that is a good idea is that these countries hit the lower bound, of zero. We have an inflation target centred on 2½, and we had 300 points left when we got to the bottom that we could have used but did not need to. So it seems to me that this problem, in our case, has not—has not anything like—arisen. I think it might well be argued that some of these countries should have had higher average interest rates than they did. But they did not actually need a higher inflation target to do that. That is a line of argument that many people ran—that rates were just too low.

The other thing to say is that, if you look at other countries—let us take Japan—they never had an inflation target anyway, and neither did the US. The UK did, but as many countries did not have them as had them that got into trouble. So I do not think that where the inflation target was set was actually all that germane. In the American case, the real problem was that they could not get the 30-year mortgage rate down. The Fed funds rate went to zero, but it did not do much to bring the rate that the borrowers actually pay down. This is the point we were making earlier: it is the rate the borrowers pay and not the central bank rate that matters, because not many people borrow at that rate. The central bank rate is just a tool to move that other rate. And, in their case, the tool did not bring down the 30-year rate—in fact, that rate, I think, only started
falling when the Feds started buying the Fannie and Freddie paper. So I think the fact that they hit the zero bound and it was ineffective says that something else was at work there, not what the right inflation rate was. After all, most of these countries operated perfectly well for 40 or 50 years before the high inflation of the seventies, with very low nominal interest rates and low inflation rates, and they never got into a liquidity trap in those days. So I would not agree at all with the sentiments in that paper on inflation targets.

Mr FITZGIBBON—You have been making the point on economic capacity since November last year that we go into this upswing with less capacity than was the case coming off the last two, much milder downswings. You mentioned that again today and it has been reinforced by others. On each occasion you have talked about employment and underemployment in particular, but you have not said much about capacity utilisation on the part of firms. It is not an exact science, but your chart has manufacturing well down, with much more capacity there, and you give an explanation for that: world demand. However, the other sectors, construction and services, are pretty much where they were back in 2001-02. Can we assume from that, and this is a very genuine question, that your absolute focus is on employment? In addition to that, on that page of your statement you say ‘with considerably less spare capacity than earlier thought likely’. Is that earlier than November 2009 or earlier than today’s hearing?

Mr Stevens—I could answer this in terms of how the growth forecasts have evolved, which is a simple metric. At one point we were forecasting GDP would fall one per cent through 2009, December to December. Now the forecast is plus two, so there is three per cent more GDP, if our estimates are correct, than we thought in those pessimistic forecasts. People were most pessimistic about April last year. If you think of where potential GDP is, you cannot observe it. But wherever it is we are about three per cent closer to it now than we thought we were going to be only nine months ago. The capacity utilisation measures are from surveys, and they are clearly well down from the highs of 2007, but that was very high. This economy was operating fully stretched and we were seeing inflation pick up—as it turned out, even a bit more than we feared at the time. So that was clearly a point of overcapacity. We have some spare capacity now but, compared with what you typically get if you have a really big downturn, we have a lot less. As I said earlier, that is good but we just have to keep in mind that is our starting point as we head off into the future. On the labour market, there are of course, as you refer to, many measures of underutilisation and so on, but as one broad summary metric it is a pretty fair characterisation that, if your peak unemployment is under six, then you are going down. That is what it looks like, just eyeballing the numbers. We are starting with a labour market that is going to get tight quicker than it has in other episodes, even the 2001 episode, where the unemployment rate was about seven.

CHAIR—As a follow up on that, one of the differences in the unemployment figures in the downturn this time, compared to some previous times, is that unemployment did not rise as much, and you have made the comment about the reduction in hours and part-time work. That is perhaps a unique feature of this occurrence as well.

Mr Stevens—It happened in 2001 as well, but it has happened more this time. Of course the hours are now picking up, so we should see that some of the take-up of labour demand is going to be more hours.
Dr Lowe—Going forward in our forecast we do not have the unemployment rate going down that quickly, because as the economy strengthens we will see average hours lengthen out and reverse that earlier decline. I think that is going to be the first thing we will see. Once that process plays its way through then we would expect the unemployment rate to come down more. But there is a reasonable amount of spare capacity there because people are working fewer hours.

Mr BILLSON—How long do you see that stickiness in jobs growth as the extra capacity is absorbed in extra working hours? Do you have a sense of how long that stickiness might be with us?

Dr Lowe—I think it is hard to tell, but over the next six months to a year one imagines that that reduction in average hours worked reverses itself. It is hard to know exactly how long it would take, but I think that is the general—

Mr Stevens—The slight irony, of course, is that the number of jobs has been rising quickly in the past three or four months, apparently, which makes it even harder to tell.

Mr TURNOUR—Governor, I think already this morning you have described former Governor Macfarlane’s comments as being ‘open mouth surgery’, and I think previously you have mentioned that Governor Bernanke in the United States has used ‘jawboning’ in the past. Would describing rates at emergency lows and more likely to have a five in front of them than a three—I think that was it last time—be described as one of those, or do you have a particular name for it when you make comments like that?

Mr Stevens—I was just responding to your questions, I am sure. There is a lot of my mouth open here this morning, and frequently that is a dangerous activity for central bankers.

Mr TURNOUR—Maybe it is more appropriate for Mr Battellino and Dr Lowe—is there a name that they give it at the bank, and if we call it an open mouth service—

Mr Stevens—They just say that the governor is talking out of school again!

Mr BRADBURY—Phil just nods when he is asked, is that right, Phil?

Mr TURNOUR—The point is, is it picked up? They were quite significant statements that you made last time, and they send clear messages to the community; they were on the front page of the local papers and in all the news headlines. Do you pick up comments that you may make in a quantitative or qualitative way, or comments that may be made around the world?

Mr Stevens—I think, yes, it makes the front page of the papers but I have noticed that anything said by the Reserve Bank that may possibly, remotely, be about interest rates makes the papers whether it should or not. Most things that are said and make the front page of the papers pass within a few days, so—

Mr TURNOUR—They were significant statements though, and obviously—
Mr Stevens—In a sense, I think they were probably confirming what most people would kind of know, wouldn’t they? If interest rates are at a 50-year low, you must have some emergency for that to be so? Most people would know that once the emergency passes you probably should not stay there. I think it is important for us to articulate that, but I do not think too many people would have been surprised to hear that—mainly only at the timing, possibly.

Mr TURNOUR—Though you made the comment today specifically about the former Governor McFarlane in relation to that. Have you picked up, or has there been work done, particularly in qualitative or quantitative data, that picks up on, and specifically goes to, the issue about statements—particularly from people of influence like you—and confidence or perceptions in the work that you do?

Mr Stevens—I am not aware of serious research on the effects of central bank comments on the real economy. There is a literature on things that move markets on particular days, of which central bank remarks are one—data is another thing. There is a literature on that, but I am not sure that any of that is up-to-date enough to have measured any potential impacts of something I said at the last hearing, I am afraid.

Mr TURNOUR—The point is though, that things you say and things that significant people in the economic sphere say do have an influence on markets and, potentially, on interest rates.

Mr Stevens—Of course, that is why we always try very carefully to speak precisely and sometimes to be a little bit less clear than you might like.

Mr BRADBURY—You are asking to be a little less animated, are you?

Mr Stevens—One of my favourite quotes from Alan Greenspan is when he said that since he had become a central banker he had learned to mumble with great incoherence.

Mr TURNOUR—It would also be fair to make the point that if the Secretary of the Treasury were to speak in a way that could influence the market, the Treasurer or Finance minister could similarly make statements that could potentially impact and influence markets and the broader confidence in the economy.

Mr Stevens—People in positions of authority and responsibility certainly must be wary of the way they speak. I agree with that. I think there are some times when you have to say things like they are—and the markets will move, but they have to move. I think one has to be careful of inadvertently giving false impressions, to be sure.

Mr TURNOUR—This is a very serious point. We are coming to the point where we have a finance minister, Lindsay Tanner, and the opposition have a finance spokesman, Senator Joyce.

Mr Stevens—I can see where we are going.

Mr TURNOUR—The comments that a person makes, if they were the finance minister, could have impacts on markets, interest rates and a range of different confidence levels in the community.
Mr Stevens—I am not going to get into any further discussion about what the shadow finance minister said. I think there has been a fair bit of that already, hasn’t there?

Mr TURNOUR—The point I was making—you have outlined the answer, anyway—is that if a person were the finance minister of this country what they say would influence, or could have influence, in the markets.

Mr Stevens—Yes. I have yet to meet a finance minister who has ever mused on any possibility about debt default of his own country, though.

Mr TURNOUR—Moving along from that, I know that in your statement earlier you said that we were moving to a more expansionary period, that things were looking more positive going forward, and that we are moving beyond the focus on the downturn, particularly in Australia. You have obviously been working in the bank through a number of recessions or downturns and you have said, I think, in some comments today, that this has probably been the smallest one since the war. Can you give us an idea about what your thoughts are, or your reflections, because in this game you keep moving on and focusing on the future. What can we learn from our response to this global recession from the way that the government and the RBA have responded?

Mr Stevens—I think that is a very important question. There is still some debate about whether it should be called a recession or not. Let’s leave that aside. If it was, it was probably the smallest one we have had since the war, I would say. It is a bit deeper than the mid-cycle slow down we had in 2001 but not all that much. What should we learn? I think the lesson we should not take is that Australia does not have recessions and that we will not have them in the future: that everything is rosy. We will have them. I do not know when, but we will. I think that that is just the nature of capitalist economies. The lesson we ought to take is that when they come you may have some scope to influence whether it is a big one or a little one. You are right: I have lived through a few recessions in the 30 years I have been in the Reserve Bank—two bad ones and then a whole bunch of mid-cycle slow downs that were fine. They are very different experiences.

So the lesson we ought to be taking is that we had a small episode here. How was that? What did we do to make that happen? You will point, I am sure, to the fiscal measures and the very dramatic easing in monetary policy that we had. Those things certainly helped to support the economy but why could we do that? How were we able to do that? You cannot just do that out of thin air. You have to build up, in the preceding years—over years and years and years—the budget surplus, the reputation for a credible monetary policy and a level of interest rates that is appropriate for the economy through time so that you can credibly do these things when an emergency comes; so that they will work. There are some countries which cannot do a fiscal easing today, even though they are in a deep recession. Greece is going to have to tighten fiscal policy in the middle of a bad situation because, over a long time, there has not been sufficient fiscal credibility built up.

We built it up through the previous government and, I have to say, the one before that as well, over many years. We built up monetary policy credibility through 20 years of hard work containing inflation. We built up supply-side flexibility of the economy through many, many, many years of arduous, grinding work on breaking down all the stuff that was wrong there. So
the lesson we should take is: all it was worth it, because it has helped us here, as well as raising our living standards over time anyway, but that we have to reinvest in all that in the years ahead. So the lesson we should take is not that we do not have recessions—that we get away with it; the lesson is that we have small ones if we have the firepower and the credibility and the presence of mind to act. But you cannot act unless you have got the scope, and we had the scope because we built it. We have got to rebuild it.

Mr TURNOUR—So recognising the work of the Hawke-Keating government, the Howard government is important?

Mr Stevens—Yes, absolutely.

Mr TURNOUR—That cash payments, though, and the economic stimulus plan were also important in terms of preventing us going into a technical recession?

Mr Stevens—As my colleague here said yesterday, I do not think there is any doubt that those measures supported demand. There was a long debate about whether they would work. I think they worked. There is no doubt about that. The debate now really in fiscal is going to turn to, as it should, efficiency and timeliness of withdrawal and all that. That is where the debate should be, because we are in that phase now. It is good to be in that phase, actually. It is good to be in the phase where the policy measures taken to avert a serious downturn worked and we are talking about the right path for exiting those and how we manage an expansion. What a great problem to have. I can name a lot of other countries that would like to have it.

Mr TURNOUR—Taking out on board, and going back to the point I was making before, having the shadow finance spokesman in my electorate yesterday saying that we were basically stimulating South Korea, China and Japan, because people spent one off $900 payments on rubbish in their homes does not really necessarily go to the point that would be a responsible statement for a finance spokesman of the country to make, would it?

Mr Stevens—I think in saying things like that, his job is to criticise, isn’t it?

Mr BILLSON—There is plenty of material to work with.

Mr TURNOUR—I thought his job was to be the finance spokesman and an alternative for the country.

Mr Stevens—Chair, I am not going to get into any more on what Senator Joyce said.

CHAIR—I think we will move on. Ms Ley, welcome to the hearing.

Ms LEY—Mr Stevens, recognising of course that the Reserve Bank concerns itself with monetary policy but also noting your comments on Australia’s strong fiscal sustainability, can I ask you broadly how important you see the Henry tax review as far as setting a framework that will make it easier for Australia to sustain adequate growth into the future?

Mr Stevens—Tax is a very complex matter. I do not know what is in the Henry tax review other than we read in the paper. I really cannot give you many informed comments about tax
matters, because it is not my field. I can certainly agree that the structure of taxation and its level is a very important factor for efficiency in the economy—and that, I assume, is a large part of why the government called for the review. But what it will show and recommend, I don’t know, so I cannot really offer a great deal of comment about that.

Ms LEY—If we leave aside the issue of the Henry tax review, are there changes to the tax system that you believe could help Australia on its path to sustainable economic growth? Are there things that you hope may emerge that would make it easier for Australia to manage its growth into the future, given that you have identified that as a significant challenge, particularly in terms of the Intergenerational report?

Mr Stevens—I do not have personally, and the bank does not have, a position on what tax matters should be changed. One issue that my predecessor identified as important at one point was the whole treatment of capital gains on negative gearing and so on, but I do not want to put a position on that. We do not have the expertise. I am a simple central bank monetary economist type so to my mind tax is about supply side efficiency. It has got to raise the revenue; we want to balance the budget—that is a fiscal policy question—and the tax system has to do that, raise the necessary revenue, and do it in a non-distortionary way. How you do that exactly is in the province of people who are experts in tax, and there can be nobody better placed than Ken to head that review in that sense. But we do not have a set of things that we are looking to see emerge out of the review. We are spectators with this particular issue.

Ms LEY—As a rural member of this committee, can I ask you for your impressions on what I think most rural members of parliament would agree is an extreme tightening in the rural lending sector. Are we seeing, in fact, two speeds or two types of lending from banks where there is a greater preference for mortgages than there are for rural and agribusiness type loans?

Mr Stevens—I was not aware that there was major evidence of lending conditions in the rural sector tightening more than for other businesses. I am not sure whether that is what you are suggesting, but I have not heard that. In fact, I would have thought there were one or two institutions in that sector who were looking to grow and who were in good shape. As for the general issue of business versus housing, that goes back to the question that was asked by one of the colleagues over here earlier on. It is true that the capital charge system does discriminate, but that is what it is supposed to do because mortgage lending is less risky and that is why a business loan costs more to get. But there is no reason that that should lead to an undue shortage of business loans over time if the risk is appropriately priced and the banks have adequate access to funding and capital, which I think they do. Phil, is there any other thing?

Dr Lowe—in our liaison we picked up that it has been very tight for firms in the rural sector but I do not think it has been any tighter than for firms elsewhere in the economy. As the governor was saying before, at the margin we are detecting things are easing a little both in the farm sector and for the general community. So it has been tight but I think the worst is probably over there.

Mr BRADBURY—Governor, as you noted earlier, you do choose your words very carefully in this setting.

Mr Stevens—I certainly try.
Mr BRADBURY—I did note earlier in your opening statement that you did take a swipe at Westpac, and this is in relation to that. That was in the context of the mortgage rates that they are charging and the extent to which they have increased those rates.

Mr Stevens—I am not issuing a criticism of Westpac. I am just noting that, if my memory is correct, those mortgage rates have risen by 98 points. So if you are a customer of that bank you had the equivalent of four Reserve Bank tightenings, not three. If you are a customer of some other banks it is three and a bit. But that is a fact we took account of in recent decisions.

Mr BRADBURY—It is a fact that you highlighted, and I am wondering whether you—

Mr Stevens—It is relevant to the decisions we make because we are noticing that, as I say, the rates people pay are moving a little bit more than the rate we are setting.

Mr BRADBURY—It is clearly a matter that is of great interest to all of us as elected representatives. My question goes to whether or not, in singling them out, you are reflecting, in fact, upon the extent to which they are contributing to competitive pressure within the sector.

Mr Stevens—No, I am not seeking to single them out about competitive issues at all. They took their decision and the other banks all took their decisions. Actually, the fact that they all chose slightly different answers says that there are at the margins certain competitive dynamics at work between them, I think.

Mr BRADBURY—in terms of the stimulus, you have acknowledged today and previously the impact of the stimulus in assisting Australia to avoid slipping into a technical recession. On the question of a technical recession, I wonder whether you would be able to offer some comments as to how significant you think it was for the country to avoid slipping into technical recession. I know that Treasury noted that consumer confidence in the months after that data indicated that we did not slip into a technical recession, that the data was at its strongest levels ever. Do you think that the mere fact that we avoided a technical recession, of itself, has been a factor which has contributed to buoyancy within the economy in Australia?

Mr Stevens—The fact that at a certain point, having had the single fall in GDP for one quarter and the next quarter being a positive and so there was an avoidance of, as you put it, ‘a technical recession’, I think that probably does have a short-term boost to the next time the consumer confidence is measured. My guess is that by the next time it is measured there is some other thing moving it around. The more general point is that it has done a lot for confidence, as it should, that our country managed to avoid a very deep downturn when many other developed countries in the world had one. That I think has done a lot not just for the monthly index of confidence but for our genuine sense of confidence about our future. I think it is appropriate we have that reaction provided we are realistic in drawing the right lessons from this episode, which I think are the ones as I outlined a few minutes ago.

Mr BRADBURY—You mentioned in your opening statement that consumer expenditure is unlikely to be the leading driver of growth that it once was. Are you able to comment on what you see as being the leading drivers in the absence of consumer expenditure?
Mr Stevens—It is not that consumers will not play any role but we were in a period for some years where globally strong consumption, falling saving rates and gearing up by households were pushing economies along, including ours. We probably stopped doing that to quite the same extent a little earlier than some others. Why? Because the resource sector build-up started to take on more prominence. That was already beginning in the period leading up to the global financial crisis. There was a temporary loss of confidence there for a little while but that confidence is back now and the period we are going into, it would appear, as best we can see, involves very substantial resource sector investment. That will be a driver of demand. We are also seeing a housing upswing at the moment, which we need—we need more houses built. That is going to be a leading driver in the next year or two, I think. If you are looking at a five-year horizon and asking what are the big picture things which are important in this economy, I would have said terms of trade very high, very large intended build-up in resource sector investment, a lot of which is getting underway, with a lot of adjustment issues that will bring, and that is going to be quite a powerful driver.

Mr BRADBURY—Can I also ask a question on the wholesale guarantee. I note there has been some criticism of the announced decision to phase out that guarantee. Could you express your view of the bank’s view in relation to whether or not the timing of that phase down is appropriate?

Mr Stevens—I am not sure where the criticism you are referring to is coming from. I think the decision was a good one. We recommended it on the Council of Financial Regulators. It is quite apparent that the availability of funding for banks generally around the world has been improving for some time. The United States ended their guarantee in October. Some other countries ended theirs in December, I think. Some other countries extended a bit but announced impending end dates. One or two other countries extended a little bit but made it harder to get. Our banks were using it mainly opportunistically—for the majors, certainly. They did not actually need it. I think it is better, when conditions allow, to get back to a world where private markets price private risk and where banks do not rely on government guarantees for funding. We have to do that at some point. I do not think we want to be in a world where the government is guaranteeing everything indeﬁnitely. That means you have to get off at some time. I think this was an appropriate time. After all, we are saying to everyone in the world, rightly, that we have among the world’s best banks. We have come through the crisis better than most. Why would we need an ongoing guarantee when other countries are letting theirs go? I do not think we do need it, so I think it was the right call. As far as I can see, it has not caused any disruption.

Mr BILLSON—I have a question on the retail bank guarantee.

Mr Stevens—This is the $1 million guarantee?

Mr BILLSON—There were some arguments for and against the permanency of it. Also, it has had a profound and quite damaging impact on non-regulated investment vehicles. There has been the freezing of redemptions on investor funds and that has caused quite a lot of hardship. What do you think needs to be done to unlock those funds so that people’s savings in those funds can actually be redeemed?

Mr Stevens—People say that the guarantee forced a lot of troubles on those entities. That might be right. But wasn’t there also a problem that some of these entities at least were kind of
offering to be like a bank deposit when they were not really a bank deposit. In a climate where there was a sudden rush to security, I have the suspicion that they were going to come under some strain anyway. It may be that the announcement of the guarantee crystallised that. Possibly that is right. I am not sure that you can really have, fundamentally, an entity that funds mortgages but offers overnight liquidity unless it is run like a bank and it really is a bank. I think there was a bit of a problem there that people had not fully understood until the crisis events occurred. What should happen from here? The $1 million free guarantee is due to be reviewed by October 2011, I think. So there is time to do that. My personal opinion—and I cannot speak for other regulatory agencies here, such as APRA or the Treasury or anybody—is that that number ought to be considerably lower once it is all reviewed. I think that we ought to move to a system where it is a bit clearer what the genuine deposit arrangements really are and have a lower limit. It is a very generous limit. It worked well, but I think the next most generous that I am aware of is $250,000 in the United States. In Europe it is more like €100,000. So ours is, by international standards, very generous. It is okay for the moment, but I think, when we restructure all this, in the final analysis that number should be considerably lower than that.

Mr BILLSON—And the frozen redemptions? Do you see the spread of that guarantee? Its duration and scale is one issue, but in terms of the—

Mr Stevens—I am not sure whether, if that guarantee were suddenly removed, people would flock back to the mortgage trusts and others. I do not know, but I think people might for some time take a slightly more cautious attitude to those products.

Mr BRIGGS—We have been talking about lessons from the crisis and lessons going forward. I am interested in your thoughts on a potential issue which is still to be debated. You commented about the increasingly complex environment you are operating in when setting monetary policy. You said it is more difficult now than in the past because of the interconnections globally and so forth. You also commented in the February 2009 publication that your independence comes with accountability and a higher requirement for transparency in the form of published reports and analysis, open parliamentary scrutiny, publication of minutes and so on. Do you think it is time to look at the make-up of your board? Given the complex nature of the environment you are operating in, do you see a need, as Professor Adrian Pagan has argued, to have more expertise on the board? It is good to have business leaders on the board, but I am sure you engage regularly with business leaders and get that advice from them. Do you think it would be useful, given the independent operations of the bank—

Mr Stevens—I am a bit reluctant to open up that line of discussion very much. It is not my prerogative to set the structure of the board. There is an interesting history here. In 1945, when the central bank was the Commonwealth Bank, the board was actually abolished. The same legislation that gave us the charter that we still have also abolished the board and in effect left all the power in the hands of the governor. The board was then reconstituted in 1951. The board we have now is the same board. We have the same mix of internal and external members—the Secretary of the Treasury is a member—and we have a governor, a chairman and so on. So we have had this sort of a board for almost 60 years. I know that Adrian made those remarks, but, on the other hand, one would have to say a couple of other things. Firstly, I would say that in recent years, if we judged by the results, this structure seems to have been working pretty well. The other thing—
Mr BRIGGS—But the environment is changing. You have commented that the environment is changing.

Mr Stevens—Yes. The other thing I would say is that in Australian society, at least hitherto, having a board made up of men and women from commerce and academia and the general community—not just officials and monetary experts—has probably given us more legitimacy with the average man and woman in the street than we might otherwise have had. And that is an important thing to have. That does not mean it is necessarily ideal forever. I am the chairman of this board—and I defend it and think it works well—so it is very hard for me to engage in speculation about what might be better. It is certainly a unique board among the central banks of the developed countries—I cannot think of any others that have our structure, other than the ones who have copied it from us, and there are few in our neighbourhood that have—but it has worked.

CHAIR—This committee is also conducting an inquiry into productivity growth and we would be interested in your views on the role of macroeconomic policy in securing long-term productivity growth, and what part does monetary policy play in supporting a revitalised productivity growth cycle?

Dr Lowe—Obviously it is incredibly important over the long run as a determinant of average living standards. The only way we can increase those on a sustainable basis is to have strong productivity growth. Our role in this is fairly limited. What we can do for the community is to make sure we deliver low and stable inflation so the people in the business community can make the right decisions. If you look back through economic history, if you have high and variable inflation resource allocation in the private economy tends to get screwed up and you end up with lower levels of productivity growth and lower living standards. What we can do for the community, what we can do for productivity growth, is deliver low and stable inflation. Outside of that, we have very little influence. It really comes down to the structural policies that governments put in place and the incentives for private business to innovate and do things better. That is really beyond our remit.

CHAIR—The governor has spoken in the hearing today about the five-year outlook for commodities and the type of investment that is going into that. Clearly there are productivity issues there. I am not sure whether you want to make any comments in terms of that, other than those you have made already.

Dr Lowe—Over the next five or six years we are going to see very significant increases in our resource exports. There are various parts of the supply chain, particularly in coal, where there have been issues. Our understanding from talking to participants in those coal chains is that progress is being made and we are seeing very, very high rates of investment which are going to deliver I think in the next two years quite high rates of increase in resource exports. There have been issues; I think they are being addressed by these very high levels of investment. One issue that has been around for a while and I think will continue to be around is that the recorded productivity growth in the mining sector is quite low at the moment, but the value added is quite high because the prices the miners are getting are high. So we are getting, on the face of it, quite low productivity growth out of the mining sector but the actual value added, or the income we are getting as a society, is quite high. So that is just a caution on interpreting the productivity data, because the prices we are getting are historically high and that is allowing the mining...
companies to extract ores and coal and iron ore that is probably of lower standard than otherwise would be mined but the price is high, and that ultimately helps our living standards.

**Ms JACKSON**—One thing that has become clear to the committee is that the measurements of productivity are not completely satisfactory, particularly in an economy that places increasing importance on the services sector, where there is limited factoring of that part of the sector into the economy. From a personal point of view, there is a lot of work done in our economy that is not paid and therefore not counted in these sorts of productivity measures. I note the discussion earlier with Mr Briggs about concerns about labour unit costs increasing. I raise that because there is a substantial issue in my view about the under-representation of women in the workforce. It is clear that there is a substantial gender-pay equity gap in existence in Australia, an average of seventeen per cent and in some industries as high as 35 per cent. I would argue that the increase in wages costs, albeit not able to be broken down into labour unit costs, would be offset by a substantial increase in the participation of women in the labour force and therefore overall a national improvement in productivity. I guess I raise this because improvements in productivity are essential, from what you have said, in ensuring that we continue to have recovery and an improved national economic position, but there are some real question marks about the accuracy, or the appropriateness, of our current productivity measures. Would you agree?

**Dr Lowe**—It is very difficult to measure productivity in the services sector; I would agree with that. And it is difficult to measure how it increases through time.

**Ms JACKSON**—That is a big issue if we are going to have a simplistic position that pressures on wages costs are necessarily always a bad thing. I think your concern, Governor, was that any increase in unit labour costs is not a good thing.

**Mr Stevens**—What I said was that, in the scenario that was painted in the question, a rise in unit labour costs is a contributor to higher prices. That is inflation. That is not productivity, because if it is a unit cost it is over and above productivity. As Phil said, it is very hard to measure productivity in general and especially in the services sector, but in the end the test, for us, of wages and productivity and how it all falls out is what happens to prices, because it is our job to stabilise that.

**Dr Lowe**—The only other observation I would make here is that the least productive thing that a society can do is to have sitting at home people who want to work and who do not. Over the last 10 years we have made tremendous progress in bringing into employment people who wanted jobs, and increasing labour supply of women is part of that story. When you look at output per hour worked, it has not grown particularly strongly, but if you look at output per potential worker it has grown reasonably strongly because we have been able to bring into paid employment people who wanted to work and who could not. At least to my mind, just looking at output per head is only part of the story. We have to look at output per potential worker, and there the story is a bit different.

**Ms LEY**—Dr Lowe, could I have your comments on the link between our national savings and our future productivity growth, and in particular what you think the role of superannuation might be in contributing to that.
Dr Lowe—In the end, the productivity growth is going to be driven by how much capital we put in place, how much investment we put in place and how efficiently we use our capital and our labour. The superannuation is really about the financing of that. If we look forward, at least in our own forecasts, we have very high rates of investment return in Australia, so that is going to mean the capital stock is going to rise quite quickly and we are going to have to fund that. Superannuation is obviously going to be part of that, but I really see that it is how much capital investment we do in the country and how efficiently we use it. They are the main determinants, and superannuation is part of the funding of that.

Ms LEY—You do not feel we need a certain level to guarantee that contribution by superannuation?

Dr Lowe—No. I think the funding for the investment will come. Partly it will come through the superannuation funds, partly it will come from the banks using domestic savings and partly it will come from foreign investment. But because the return on capital in Australia is high—we have high investment—I think we will fund it. It will come from a variety of sources and super will be one, but it will just be one.

Mr TURNOUR—My question goes to the issue of responses going forward. Acknowledging that it looks like unemployment has peaked, in my own region the regional unemployment figures were out yesterday and, looking at the last three months, in November unemployment was 10.3 per cent, in December it was 10.6 and January’s figures were 12.3. Unemployment generally does rise seasonally in Cairns because of the slowdown in the tourism industry, but clearly unemployment was around five per cent before the GST and it is still significantly higher than that. What is your data picking up, and how do you look at variations across the country in terms of responses? It may be more optimistic in some parts of the country. I understand Western Australia is picking up with mining over there, as are sections of Queensland and New South Wales. How do you take that into consideration in decision-making on monetary policy?

Mr Stevens—the figures we have for Far North Queensland do look more or less as you say. In other parts of the country they look considerably lower. I think we have come at this question in the past. We are not able to target or precisely manage the conditions for different parts of the country—we have only the one instrument. All we can do is to set what we think is the right level for the average. I would have to say, I think most parts of the country at the moment—I fully accept that Far North Queensland is an exception, and I am not sure I can give you all the whys and wherefores for why that is—but in most parts of the country unemployment is pretty low, which is good of course. I do not have a solution for the double-digit story up there, I am sorry.

Mr TURNOUR—We are working on it. Before there was a lot of talk about a two-speed economy, the West and Queensland. Do you see any risk of that developing further?

Mr Stevens—Yes, I think it is going to be a two-speed economy. I have said publicly that I think all those issues of geographical differences and industry differences are likely to re-emerge with a vengeance, if we take as our predating assumption that the story is that Asian, Chinese and so on demand for resources continues to be strong, that those parts of the world continue to grow, that our economy naturally will want to adjust to those changes in relative prices. That is how it presents to us. The relative price of resources is high, that of manufactures is low.
There are structural adjustment implications of this for our economy, and we have said this. We cannot make the structural adjustment occur, actually, and we cannot really make it any easier. It is going to be prompted, as we were talking about earlier: wages and conditions in some sectors will get higher because they want to attract the workers, other sectors will not be able to match that and the people are going to move. The exchange rate is high. What that does is put pressure on import competitors, manufacturers and so on, and some of our demand for those products gets spilled abroad to cheaper areas. That is how the economy copes with these things.

So the structural adjustment issues are there and they will, I think, probably intensify in the years ahead if this scenario pans out. It may not, of course—something else may go wrong. But I think those issues will be quite important ones. I am not going to be able to provide you, though, with any answers. They will not go away unless the initiating set of forces in Asia goes away, so the economy will, one way or another, adjust to them. The issue for policymakers, governments in particular, is how to make that adjustment work easily and smoothly. I do not think you can really resist it.

Mr BILLSON—One thing that I think does not get enough attention is the software, the people. What is your take on entrepreneurship with these pressures on costs, the attractiveness of funds going into non-productive investments and the risk aversion that is around? What do you see as the future, particularly in view of the young audience here, for encouragement of entrepreneurship and innovation?

Mr Stevens—I would hope that young entrepreneurs would maintain their optimism. We talked earlier about what a boost to confidence it was that we did not really have a big downturn. I think that is important. I have said all through this episode that Australians have a lot of reasons to be confident about the future of our country, that we are up to the challenges we face if we just approach them sensibly. So I would hope that people would maintain that confidence.

I think entrepreneurship has probably always been hard, hasn’t it? Has it ever been easy to get capital for a start-up? I think most people who build a business from nothing probably have always mortgaged the house, scrimped and saved—I don’t know. I am not saying that it should be, but it always has been, I suspect, that way. Is it any easier now? It is not. But the kind of people who want to do that, I suspect, are the sort of people who probably will not be put off by the roadblocks and hurdles and so on that life throws up. That is my guess. I would hope we could be confident in the future of that entrepreneurship here and maybe work at recognising it.

CHAIR—Governor, we have two more student questions to conclude today. The first one is from Boyan Taseski from Daramalan College, which I earlier omitted to say is also represented here. My apologies to the college.

Boyan Taseski—Mr Stevens, earlier you mentioned your prediction on growth. I would like to know how confident you are in this prediction and whether you have considered consumer confidence, as this could be a volatile factor given it is an election year. No doubt we will be bombarded by messages from the media about doom and gloom and many people will question whether they will still support the government. The media will play a big role in making consumers nervous. So I am wondering whether you are confident in this prediction.
Mr Stevens—I agree that consumer confidence can swing. I agree that the media can, perhaps, be prone to bombard us with doom and gloom. I think that is a constant; I don’t think that is a new variable. Many business people would tell you that people become more cautious in the lead-up to an election just because they do not know the outcome and they wait. That happens every three years, so it is presumably something we cope with and get over. Everybody also knows that the election is going to be this year sometime. It could be that some new event or twist or turn will damage confidence, but I have as much confidence in our forecasts as I ever do. My colleague is laughing, because he knows—I have made many forecasts in my life. I have seen many, many, many forecasts go wrong. So I have the appropriate degree of confidence in them. But I think they are as reliable as they normally are. That is as good as we can hope, I think—and I think we will get by the election okay.

CHAIR—Thank you, Boyan. The next question comes from Amanda Cross from Canberra Girls Grammar School.

Amanda Cross—Mr Stevens, the government and opposition climate change policies are to be funded very differently. Would you support either a market driven or government regulated model, as have been outlined by the relevant parties? Which do you believe would be more sustainable for the Australian economy?

Mr Stevens—I am going to duck this one on the grounds that I just do not know enough about climate change policy to give an informed opinion. That is first. Second, the bank’s job is mainly to keep its mouth shut on this matter as on so many others. So I am sorry, but I cannot choose between them for you today.

CHAIR—Thank you, Governor and other representatives of the Reserve Bank, for your attendance here today.

Resolved (on motion by Mr Turnour):

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

Committee adjourned at 12.29 pm