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Members: Mr Craig Thomson (Chair), Mr Ciobo (Deputy Chair), Mr Buchholz, Mr Stephen Jones, Dr Leigh, Ms O’Dwyer and Ms Owens

Members in attendance: Mr Buchholz, Mr Ciobo, Mr Stephen Jones, Dr Leigh, Ms O’Dwyer, Ms Owens, Mr Craig Thomson

Terms of reference for the inquiry:
To inquire into and report on:
Reserve Bank of Australia annual report 2010
WITNESSES

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Committee met at 9.30 am

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

LOWE, Dr Philip, Assistant Governor, Economics, Reserve Bank of Australia

STEVENS, Mr Glenn, 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 of Australia and members of the public and the media to today’s hearing. Since October 2009, the RBA has lifted the cash rate seven times, taking it from three per cent to 4.75 per cent. The RBA in its November board meeting minutes commented that the outlook for growth in the resources sector was very strong and GDP growth was expected to rise gradually. The RBA board further commented that some of the uncertainties that had been a reason to keep interest rates steady over the past few months had lessened recently, even though they had not dissipated completely. The RBA will be examined over the risks that it had to balance in arriving at this decision. The committee will scrutinise the RBA over its growth projections for the resource sector and the potential for increasing capacity constraints. At the same time, the committee will seek an update on the current state in growth projections for the non-mining sector.

Once again, on behalf of the committee, I welcome the governor and the senior officials of the Reserve Bank of Australia to this hearing. I remind you that 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 of the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. Mr Stephens, I invite you to make an opening statement before we proceed to questions.

Mr Stevens—Thank you, Mr Chairman. I thought it would be useful to try to pick up from where we left off when we last met with the committee, in February of this year, and then talk about how things have changed since then. At that time, it was becoming clear that the recovery in the global economy was proceeding faster than many people had expected. It was also clear that the strongest performance was in the emerging world, while recoveries in countries that had been at the centre of the financial events of 2007 and 2008 were relatively subdued. Global financial markets had continued to improve, but they were paying close attention to the rise in sovereign debt in a number of countries.

At that time, people were talking about an expansion in global GDP in 2010 of about four per cent. As it turns out, it looks like the outcome will be stronger than that: currently most forecasts are for around 4¾ per cent for 2010 global GDP, which is clearly above trend. The pattern of growth is still rather uneven. The additional strength is still tending to be concentrated mainly in the emerging countries and growth in China and India looks to be running at a pace of around 10 per cent this year. In contrast, growth among the G7 countries of about 2½ per cent—and that follows a contraction of 3½ per cent in 2009—will leave a considerable margin of spare capacity, particularly of unemployed labour.

Financial markets and policymakers have maintained, and indeed increased, their focus on issues of sovereign debt sustainability. First Greece and more recently Ireland have sought
financial assistance from European partners and the IMF after a change in their circumstances and a large rise in market borrowing costs left authorities with little other option, even after deep cuts to spending. Across continental Europe and the UK, governments are embarking on a path of fiscal consolidation in order to put public finances on a sounder footing in the face of increased obligations and reduced revenues. These programs unavoidably will have some short-term dampening effects on economic activity in those countries, which will likely become clearer next year. But scope to do much else for those governments is really rather limited.

In this environment it is no surprise that the major central banks are mostly maintaining very low interest rates and in some cases increasing the sizes of their already expanded balance sheets through asset purchases. These actions are designed to impart some further stimulus through reducing long-term interest rates, which are already very low, even further or via effects on private sector balance sheets. But at the same time many other countries, particularly in the emerging world, have moved to tighten their monetary policies this year, in recognition that they have had a robust recovery in output. In most cases in Asia, with Japan a conspicuous exception, the rise in activity along the upward part of the V in the V-shaped recovery has been seen and the pace of growth has to moderate somewhat if overheating in those cases is to be avoided.

The combination of very low rates in the world’s major financially developed countries on the one hand and strong growth and tightening monetary policies in Asia and Latin America on the other could be expected to place pressure on exchange rate regimes, and so it has proved. There have been substantial capital flows seeking the expected higher returns in emerging economies and a rise in asset values in many of the recipient countries. A number of them have responded with the imposition of capital controls and other measures to contain leverage, especially in housing markets. In this environment, where the policy imperatives differ so much at the moment across countries, the intensity of international discussion about exchange rates was bound to escalate, and so it has, quite noticeably.

A year from now we will, I think, have observed a little more clearly than we can just yet some moderation in the pace of global growth, from being clearly above trend this year to something closer to trend—at least, that is the assumption that we are making, and that is consistent with other forecasts. The emerging world, as I say, clearly needed some moderation, while the major countries working through the aftermath of banking crises will, if history is any guide, continue to find it hard going for a while yet. How much progress we will have made in another year in resolving the so-called global imbalances remains unclear.

What is clear is that the strength of global growth thus far, and the particular pattern of growth in key emerging economies, with its very strong emphasis and impact on the demand for steel, has had a major effect on Australia’s terms of trade. These have returned to, and in fact exceeded, the six-decade highs we saw two years ago. It is our assumption that prices for key resource commodities will not remain as high as they are now but will in fact decline somewhat over the few years ahead. Even so, developments since we met in February have led us to lift our estimates for the terms of trade for the 2010-11 year.

When we met in February, I suggested that real GDP growth for Australia this year would be a little over three per cent, and a little higher than that—maybe 3½ per cent—in the next couple of years. It will take only pretty moderate growth in the second half of this year to achieve that number for 2010. Next year, growth could be a bit stronger than we had expected nine months
ago, though there are of course still numerous areas of uncertainty. Measured in nominal terms—and this is an important point—the current dollar value of GDP is rising at about 10 per cent a year, which is a very strong number, because of the rise in the terms of trade.

   Consumer price inflation has returned to rates consistent with the target. It is about 2½ per cent over the last year in underlying terms and about 2¾ per cent in headline terms over that period. Clearly, that is a marked improvement from two years ago, when CPI inflation reached five per cent. Of course, we expected a significant decline in inflation when we started to lower interest rates in September of that year, and that has come through.

   Sometimes, this process of disinflation, or lowering the inflation rate, can be quite costly in terms of lost economic activity. That is often the case when higher inflation lasts long enough to become embedded in inflation expectations. But that did not occur this time and the result was that inflation came down with relatively little short-run cost to output—much as had been the case in 2001 and in 1995, which I think are the comparable previous episodes. Of course, the intention of having an announced objective for inflation, as we do, is for inflation expectations to be well anchored. That helps not only economic efficiency but also stability.

   It is unlikely, though, that we will see inflation fall much further from here. We will probably see some ongoing dampening effects of the rise in the exchange rate because that usually takes some time to come through, so we will not have seen all of the effects of that yet. Growth in labour costs, however, is no longer declining but rising. The overall pace, as we can see in the aggregate figures, could not be described as alarming at this point, but the turning point is behind us. Nor is the growth of the economy overall falling short, in any significant way, of potential growth; if anything, over the past year the growth of demand has risen considerably faster than the likely growth of potential output—something that you can only do if you have a lot of spare capacity or a rise in absorption from the rest of the world, which we have had. At this point, my assessment would be that the gap between actual and potential output is probably not all that large. Another factor for inflation that has been important is the pace of growth of utilities prices, which have been very high. We think that has probably peaked now, but it will likely remain pretty high for a while.

   Over the coming year, we think inflation will be pretty close to where it is now—that is, consistent with the target. But looking further ahead, in an economy with reasonably modest amounts of spare capacity, the terms of trade near an all-time high and the likely need to accommodate probably the largest resource sector investment expansion in a century, it seems to me that the medium-term risks on inflation probably lie in the direction of it being too high, rather than too low.

   Last time we met, I explained that it was important that monetary policy not overstay a very expansionary setting once it was clear that the danger of a really serious contraction in economic activity had passed. At that stage in February the board had lifted the cash rate three times in late 2009. Most lenders raised their rates by more than the cash rate, given that their cost of funds had been moving up relative to the cash rate. I noted that the board was taking account of those shifts in deciding the appropriate setting of the cash rate. Most rates, though, remained below normal at that stage. I also said that if economic conditions evolved as we expected, further adjustments to policy would probably be needed over time to ensure that inflation remained consistent with the target.
In the first half of this year the board did indeed make further adjustments by lifting the cash rate to 4.5 per cent. That was roughly 100 basis points lower than what we would once have considered to be ‘normal’. In fact, 4.5 per cent was very close to the lowest point the cash rate reached in the falls in interest rates in previous cycles, but it resulted in borrowing rates pretty close to the average of the past decade. So it could be considered as ‘normal’, allowing for the changes in lending margins. The board judged that to be an appropriate point at which to rest for some months. That allowed some time to assess the effects of earlier decisions and also to gauge what was happening in the rest of the world.

Most recently, as you said, Chair, the board decided to lift the cash rate by 25 basis points earlier this month. Many lenders raised their rates by more than that. These moves have left the overall setting of monetary policy now a little tighter than average, as judged by the interest rate criteria. Of course, we are aware as well that, particularly for some business borrowers, non-price conditions remain tighter than they were for some years prior to 2008. Overall, and also taking account of the exchange rate that has risen substantially this year, we judge this to be the appropriate setting of policy for the period ahead.

As the minutes from the board meetings recently make clear, these recent decisions were quite finely balanced. Quite reasonable arguments could have been made to wait a little longer before taking this step. Good arguments could also be offered as to why, when we looked ahead, it was prudent to take an early modest step in the tightening direction. On balance, this month the board judged that to be the better course. This sequence of decisions was taken in the same framework that has guided our policy for nearly two decades now—namely, seeking to keep, so far as we can, the growth of demand in the economy sustainable so as to achieve an average inflation rate of between two per cent and three per cent.

I would like to note, incidentally, that the recently re-elected government has once again committed, as have I, to that framework and that framework will continue to guide our decisions. With that, my colleagues and I are here to respond to your questions.

**CHAIR**—Thank you for that, Governor. We will go up and down the table today, but if committee members have a question that flows from a question that another member has asked then let me know and we will deal with that at the time, rather than waiting and coming back. I would like to kick off, Governor. In relation to the decision in November, reading the minutes of the November and October meetings and comparing the two, in October the board decided to hold on interest rates when, arguably, the conditions in October were more likely to have a rise than in November. Once you had made the decision in October not to rise, why did November see a rise when in fact inflation figures appeared to be more under control, the capacity constraints in the labour market appeared not to be quite as critical as perhaps they were in October, investment in relation to non-residential building had started to drop and house prices had remained consistent? When you look at the conditions on which you made a judgment in October not to rise, what conditions changed to make you change that view?

**Mr Stevens**—Often with a finely balanced decision, where the case is almost made but not quite one month, you are going to go a month or two down the track and find that the case is now a little bit clearer. Let me comment on a couple of those aspects. Firstly, I read that recent round of inflation data as pretty much in line with expectations. It is true that compared to many forecasts the quarterly outcome was a touch lower. There was some help from falling food prices
there that I do not think we will keep getting and, allowing for that, I do not think that the CPI outcome was view changing. Indeed, the medium-term inflation outlook that we have now is pretty much unchanged from what it was before. The producer price data, which people have not focused on all that much, showed a pick-up in pressure. That may or may not persist and it may or may not show up fully in consumer prices, but that data was probably a touch on the higher side even as the CPI, for the reasons I have described, were a touch on the lower. Generally speaking, inflation is at about 2½ per cent in underlying terms, which is about where we thought it would be at this time.

One of the issues that we have been grappling with for some months is what is going on in the rest of the world. There are several elements to that. A lot of people have talked about a double-dip recession in the US. It is till uncertain, but I do not think the US is going into a double dip at this point in time. That is probably getting a little bit clearer just now than it was three or four months ago. As to the uncertainties in Europe: as we have seen, they ebb and flow and they are increasing just now because of the concerns associated with Ireland and so on. On the other hand, another uncertainty we had was: just how much was the Chinese economy slowing down? That obviously is a critical variable for Australia. The conclusion we had reached by this month’s meeting was the that slowdown has been not greater than expected; if anything, the Chinese economy is now showing more concern than they were about potential overheating. China’s growth rate is probably running at about 10 per cent for this year, as I said.

So some things that we were uncertain about, and that were reasons to wait a little while, remain. And we had time to wait because we had moved back to normal quite promptly, and the whole point of doing that is to buy yourself time to then sit while other uncertainties get resolved. So some of the uncertainties we had remain, but some seemed to be less acute than we felt they might be some months earlier. In the mean time, as we know, there is a very big event, a very large terms of trade event, which is occurring. In the near term it may actually be, in a pure terms-of-trade sense, even bigger than we thought six months ago. As each month goes by, you are closer to those impacts coming through the economy. So you are in a period where you are waiting to see how certain things resolve one way or the other—but you know that you cannot wait forever—if a central outlook of the terms of trade story is still going to come true, which it seems at this point still that it is. As each month goes by, you are closer to the point where you have to take a step to respond to that. Reasonable people can differ about these things—and we had quite a long discussion at both these recent meetings about when a step might be taken—but on balance, the way we came down was that, in October, I personally did not think the case was quite made but I was persuaded that we were across the line in November.

CHAIR—You can understand though that, in terms of this argument and from what you have just said, there does not appear to be anything other than clarification of numbers, not a view-changing new figure. There is an argument that the Reserve Bank has been trigger happy in terms of—

Mr Stevens—I do not think we have. Some people will make that argument, sure. But we have been saying for quite some time that, if things worked out as we expected, we would most likely have to go to some degree of tighter policy at some point. So I think what we have done has been quite consistent with the way we have articulated that over time. Yes, you can always make the argument that it is too soon. But, having been involved in this process one way or another for quite a long time, I cannot think of very many cases in history where we looked back

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and thought, ‘Yep, we tightened too soon.’ I can think of several times where we looked back and thought we should have tightened a bit earlier. I think that if we are doing it right the decisions will be finely balanced most of the time—that is where we should be—and we will probably move a little bit earlier than the moment when it is clear that you have to. That is if we are doing it well. There is some risk that you do things you do not need to do—I agree with that. We have to balance that risk, obviously, against the risk of getting behind the game. Historically, for many central banks, including us, that has tended to be the mistake that we made.

CHAIR—Are those risks heightened because of the domination of the resource sector in terms of growth for the economy, the fact that there appears to be a two-speed economy and the effect that these rises have on the non-resource sector?

Mr Stevens—There is a multi-speed story, even within regions, I think. To some extent that is always true in the economy, but it is likely to be more true in an environment like the one we are in now. This makes things more difficult—that is certainly true—but when you look at the size of the shock that we appear to be experiencing via the terms of trade this is a very, very large event. This is a once or twice in 100 years event. If you ask yourself how likely it is that you are going to go through an event of that magnitude and not have to have some degree of restraint at some point in the process, that is pretty unlikely—very unlikely. That is the big picture with which we have to try to grapple.

CHAIR—Looking to the future, given the finely balanced decision and the argument that it possibly could have gone too early, you are saying that it is better to have done that. You said in your statement that you judge this is the appropriate setting for the period ahead. Does that give some comfort to mortgage holders that we are at the level that we are going to be staying at for the foreseeable future?

Mr Stevens—That is the question everyone wants to ask, isn’t it?

CHAIR—Of course. What does that statement mean?

Mr Stevens—What it means is that for the period we are going into in the near term I think this is about the right level. At the moment, most commentators do not anticipate and market pricing does not anticipate any further near-term change by us for quite some time. I think that is probably a reasonable position for them to have based on the information we have now.

CHAIR—I have a couple more questions in relation to the banks and the movement of their interest rates. You explained in your statement that the Reserve Bank took some of that into account in the past. Did you anticipate with this last increase that we would see the sorts of increases that the big four banks made in addition to the movement in the cash rate?

Mr Stevens—Let me be clear: we did not just take some of it into account. When I say that we had reached the period of what we would call normal, that was calibrated off loan rates, basically. So the cash rate had entirely adjusted for the shift in bank lending margins we have seen over the past several years. When we were raising rates in 2007 and 2008, we raised by less than we otherwise would have. We cut by more subsequently and we have raised by less since, because of the recognition of these shifts in margins. We cannot perfectly finetune this from
month to month because we cannot be certain exactly what decisions banks will make, but over time the cash rate has pretty much exactly, fully offset the shift in margins that has occurred.

What did we know about what they were going to do? I think it was a reasonable presumption that several institutions were likely to raise their rates by more than we did. We all knew that—you just read the newspapers. That was clear. We cannot be certain by how much, of course. But they have done what they have done and from here we take that change into account in all the decisions that we make, not just this month but in all future months.

CHAIR—Mr Battellino made some comments in relation to costs for banks in terms of their funds. In fact, he said:

The truth is, the biggest increase in the cost of funds that banks have experienced is on their domestic deposits …

Isn’t that a choice that the banks have made in terms of seeking to increase the domestic deposits they have as part of their funding mix?

Mr Stevens—They have sought to do that to increase the share of their book funded from domestic deposits and to lessen the share funded through wholesale sources. It is pretty obvious why that happens and I think it is prudent of them to do it. What we have seen in the past several years is that those wholesale funding sources, which for some years up to the middle of 2007 were very available, very inexpensive and, apparently, quite reliable and quite stable, changed dramatically after the problems began in 2007 and especially after the Lehman failure in September 2008. I think every banker in the world and every supervisor concluded that it was a more unstable and risky source of funding than had previously been assumed and that banks, therefore, needed to change their funding mix more in the direction of things that could be expected to be stable. Our banks have done that. I cannot say that I regard that as something to regret. I think it is probably prudent. What that has meant is that there has been much more intense competition to raise funds by financial institutions in that space than there had been before. You have seen that in the rises in their costs. Relative to the cash rate, the cost of several types of deposit funding has increased quite markedly over this period.

CHAIR—Hasn’t that meant that, because the banks have chosen to take this decision in relation to seeking to raise their level of share in terms of domestic funds, that has come at the expense of competition in the lending market?

Mr Stevens—It is competition. It is competition in the market to raise money. I think, globally, the big picture here is that for many years up to about two or three years ago there was very intense competition to lend money because the funding was easy. Suddenly, as a result of these various events that we are all familiar with, the competition now is not to lend money as much; the competition is to get funding.

CHAIR—That is a decision that banks have taken.

Mr Stevens—It is a marketplace reality. I do not really think the banks have a great deal of choice here. The people supplying the wholesale funding are more reluctant and they charge a higher price. Pretty much every supervisor in the world is telling their banks to rely less on wholesale funding because it is risky. The rating agencies say it. My suspicion would be that, if
the financial institutions could have got away with continuing the old pattern, they would have
because they found it attractive and profitable, but they did not have that choice. They certainly
took decisions to try to raise more deposit funding but it was a decision on which I am not sure
they had a great deal of choice in taking.

CHAIR—It certainly has not had an effect on their profits. I have here a chart showing over
the last 10 years the growth in Commonwealth Bank profits. As you can see it is a pretty
impressive rise that has continued to happen. How is someone, who has a mortgage with the
Commonwealth Bank or one of these big banks, expected to feel when they see figures like the
profits that banks continue to make and the justification that banks need to raise their margins?

Mr Stevens—But I think that, if we prepared a chart like the one you did there in absolute
dollar values for the profits of a whole bunch of large listed Australian corporates, they would
look very like that chart. The rate of return on equity that the banks are earning is good. It is
probably not, at this point, as high as it was some years ago. As we have said before in the
committee, if my choice is between banks with good profits and banks with no profits then I
choose the former every time from an overall macroeconomic point of view. People look at the
overall size of profits in billions of dollars, but we need to be careful not to forget the size of the
capital that is invested in these institutions, because you have to compare the two. The rate of
return on equity of 15 or 16 per cent—something like that—that they are earning is good, but
many Australian corporates would be looking to earn those kinds of rates of return, not just
banks.

CHAIR—But, when you see that level of profit, surely if the banks had not moved their
margins above and beyond the cash rate—we are not suggesting that they are in any way in
trouble or that they needed to do that to continue to exist; they were certainly in a very sound
position—

Mr Stevens—You do not stay in a sound position in any business if the price of your product
does not cover your costs, including your costs of equity. I think there can be a reasonable
discussion about whether so many basis points are strictly necessary and so on—sure—but over
time I think the thing that, maybe, has not had much focus is that the overall bank margins that
we see today are a little higher than they were a couple of years ago but, compared to 10 or 15
years ago, are much lower, particularly in the mortgage space. That is a result of competition and
efficiency gains, and most of those gains actually are still in place today, compared with, say, the
year 2000 or the year 1995. It is quite different to then. We are arguing about a small backtrack a
little way back up that curve but, when you look at that story in broad historical perspective, the
overall net interest margins have been fluctuating between 2¼ and 2½ for about four or five
years. There is not a lot of change.

CHAIR—But you would understand that, from a consumer’s point of view, when they see
that level of profit they see that banks, when the cash rate goes up, are increasing their rates by
more than that but, when the cash rate went down, there often was not the full flow-on in terms
of that reduction in cash rate, and there is increased mortgage pressure on families at home.

Mr Stevens—But in the end the question is really whether all those people with a mortgage
are paying seriously higher rates than they should be from an economic management point of
view. What I am saying is that I do not think they are, because we have pretty much offset the
change in the margins by doing different things in the cash rate from what we would have done had the margins not shifted.

CHAIR—Would you accept that changes in interest rates on the size of mortgages that exist now have a greater effect on family income than they did in historic terms?

Mr Stevens—That has to be true, because the size of debt relative to income is much higher than it used to be. That, of course, is why, with the interest rate moves we do today, we agonise over whether we should do 25 or not and which month it is. It is not that many years ago that routinely it was 100 points or even 200, in my memory. So what you say is true, but that is why the rate changes are calibrated to much smaller increments than they once were.

Mr CIOBO—Governor, I have a few general questions I would like to ask you in relation to your opening statement and other comments by the Reserve Bank executive before moving on to some specifics. In broad terms, though, with the interplay between fiscal policy and monetary policy there have been a number of comments made by commentators with respect to overall impact of the structural budget deficit we have in this country and to the stimulus spending—or so-called stimulus spending—by government vis-a-vis interest rate settings. I would just like to flesh that out a little bit more and seek, by way of your comments, some general views about the interplay between the two.

Mr Stevens—This is an issue we have covered, of course, many times before, as you will recall. There are various shocks hitting the economy that affect demand. Some of them are offshore; some are domestic. There is monetary policy and, of course, there is fiscal policy which has an impact on final demand in the economy. As a matter of logic, it has to be true—that if there is a major change in the fiscal approach that has an impact on demand, and we are not talking trivial numbers but significant impacts, that has to affect, compared with the alternative, the outlook and therefore it has to affect the way we take our decisions. I think that is clear and that is something we have talked about at length in the past. That has to be true.

Mr CIOBO—For example, the director of Access Economics, Chris Richardson, commented about the impact of government spending cuts on interest rates and the exchange rate. In the Sydney Morning Herald in October this year, he was quoted as saying:

The rough rule of thumb in economic models is that you have to cut by about $13 billion a year to achieve maybe a 1 per cent reduction in interest rates, which might, in turn, make maybe a cent or two difference to the level of the Australian dollar.

I am just interested in your views in the context of the Australian economy. Is there a tangible way of measuring the reduction in expenditure and the impact it has on interest rates and the exchange rate, further to Mr Richardson’s comments? Is he in the ballpark? Is it something you disagree with?

Mr Stevens—I assume that Chris’s magnitudes there come out of their model—not that I am all that familiar with the parameters of the model, but it would be a standard prediction, I think, of open economy macroeconomics that fiscal tightening will lead to a lower exchange rate; fiscal expansion will lead to a higher. I think that is the standard view. As to the exact parameters, of course, as with many things in economics you can sometimes make an estimate. There is a fair
margin of uncertainty around that estimate. I suppose the point I would make is that a $13 billion change is about a per cent of GDP, and certainly changes in fiscal impact, particularly in one year—if it were spread over five years it would not be that big a deal—would be a tangible effect. If that came out of the blue, we would be recalibrating our thinking about what we do.

The effect of that on the exchange rate, of course, is hard to tell, partly because interest rates are not the only thing that is affecting the exchange rate. The level of commodity prices itself is, in a proximate sense, quite a strong driver, and that would remain, so it is very hard to tell exactly what effect it would have on currencies, and currencies are probably the least well forecast variable in economics. But I do not think one could deny the general proposition, for a significant fiscal tightening, that a standard prediction of open economy macroeconomics would be that this leads to, probably, over some horizon, easier monetary policy than otherwise and a lower exchange rate than otherwise. I think that is a fair prediction, without wanting to endorse the particular amount.

Mr CIOBO—The actual numbers.

Mr Stevens—Yes.

Mr CIOBO—The flip side of that coin is of course that that increase in expenditure also leads to a tightening of monetary policy. In the economic context in which both your opening statement and other comments from the Reserve Bank have been made, is it reasonable therefore to assume that somewhere around that $10 billion or $15 billion increase in expenditure would see a similar tightening of monetary policy along the lines of what Mr Richardson said?

Mr Stevens—If there is a $15 billion increase in projected government spending in a single year, beyond what is already built into the forecasts—if that is proposed and enacted—then obviously that has a material impact on demand versus supply in the economy and will have a significant bearing on decisions that we would make. Let me be clear: this is an increase of a per cent of GDP compared with a baseline. It is not the increase that is already in the baseline, because that has already been factored in.

Mr CIOBO—No, but this is referring to, for example, where government expenditure is over and above that which has been forecast.

Mr Stevens—Yes.

Mr CIOBO—Let us be clear on that.

Mr Stevens—Sure.

Mr CIOBO—I note that Paul Bloxham—who, as you know, spent the last 12 years of his working life inside the RBA’s economic analysis group and a few months ago left to take the chief economist position at HSBC—wrote this week in the Financial Review:

… by choosing not to tighten fiscal policy sooner, the government has implicitly chosen higher interest rates than might otherwise have been the case.
I am interested in your commentary on that. Bearing in mind that your opening statement would indicate that the strength of economic growth has exceeded your initial forecasts: if overall levels of public demand in Australia had been significantly lower, if there had been significantly less stimulus as opposed to its being among the highest in the OECD, which is what occurred in Australia, would the official cash rate set by the RBA have been materially different over the last two years?

Mr Stevens—It would have been lower had the stimulus measures not occurred. We would have had to lower the cash rate further. I think that has to be true. I think it is a different thing to say, though, that that would necessarily be a better mix of policies. One could debate that, I think, because there was scope to do discretionary fiscal stimulus. The whole point of having budget surpluses, really, over a run of years is that when a rainy day comes you can do something if you feel you should. We had that scope. Many countries do not, but we did. It has to be true that, if that had not occurred, interest rates, I think, would have fallen further, and then of course eventually they would have had further to come back up to normal in due course than they did have. Would that have been a better world? That is a very interesting question that we can debate if you want to, because there are plenty of things that can get you into trouble with really low rates, particularly if they persist for a while. I think your analysis is correct. The interesting question is whether a world of no fiscal easing and more monetary easing would actually have been the ideal mix. It is an interesting question.

Mr CIOBO—The theory of all that is fascinating. I guess for policymakers, though, from my perspective, it is the interplay between the amount of stimulus and the lag of stimulus, and that leads me into something else I wanted to ask you about with respect to your comments on the labour market and full employment. We currently see that we are sitting at around five per cent or just slightly over five per cent. I am interested in broad terms in the RBA’s views about full employment—where, if you wanted to make a prediction, NAIRU may currently stand—and fleshing out a little bit some of the comments made earlier by Ric Battellino with respect to whether or not there is an overstatement of the employment rate and what capacity there may be, also mindful of your opening comments about actual output probably being pretty close to potential output.

Mr Stevens—I do not want to make a prediction about the NAIRU if I can avoid it, because it is an analytical construct that is useful as a device but there is no statistic you can look up to see what it is; you can only observe it from experience. I think one would have to say that when the unemployment rate was pushing to four per cent, going back two or more years, it is clear that we did see a material rise in inflation at that time. There were a number of factors at work there, but wage growth did pick up, and I think that was a period in which the general economy was tending to overheat. At present, as you say, the unemployment rate as officially measured is in the low fives, on average, over the past year or so. We are seeing some pick-up in overall wage growth, at this point not faster than we had expected would be the case, given what has happened in the economy.

Where is the line between too high and too low? It is hard to say, but I would think that this is a period now in which we need to proceed with some care. We should not expect from here to be able to grow the economy very quickly over an extended period without getting into trouble. I think that it would be unlikely that we could. That is the basis of my comment about being close to potential.
As for overstatement, I think one of the things that might be in mind there is that, if you look back at the cycle we have had, we had a fairly small fall in employment. We had a significantly larger fall in the total amount of hours worked in the economy. They are now recovering and, I think, have exceeded the previous peak. The average hours worked per person is still lower than it was. Some people would say that this could be a sign of more capacity, and that might be right. It might be as well that there is actually a downward trend in average hours worked per person. I think that might be possible, in which case it is where we are relative to that trend that you would have to try to assess.

There are at least some grounds to say that there is a bit more scope for labour demand to rise than you might think just by looking at the official unemployment rate on its face. I think that is a reasonable call. Having said that, our general assessment is that the amount of spare capacity in the economy overall is probably reasonably modest.

Mr CIOBO—Where we sit currently relative to previous exits from economic troughs the unemployment is much lower.

Mr Stevens—Very low.

Mr CIOBO—My concern is, for example, if you look at the wage price index we have seen public sector growth at four per cent compared to 3.4 per cent in the private sector, which I understand may have inverted. I would be interested in views as to whether the private sector exceeded that. We are seeing evidence now of rapid increases in both public and private sector wage price growth. The Reserve Bank has previously made comments about labour market flexibility being crucial to weathering the last the economic storm. Given moves to re-regulate the labour market, given that our unemployment rate coming out an economic trough is much lower than it has historically been, will that decreased flexibility have an impact on the wage price index and how will that flow through to inflation and your ability to deal with inflation?

Mr Stevens—As you say, we come out of this downturn—a downturn that ended some time ago now—with an unemployment rate that peaked below six, and that is unequivocally good news. That means that you have to be careful because there is less spare capacity. With the recent data on wages, I think, we would probably say those figures we had last week were not view-changing. There is a larger increase in the quarter because the fair pay decision comes through in a lump, and in the previous period there was no increase temporarily. You have to allow for that but, allowing for that, the pace of overall wage growth in the economy is gradually increasing, which is what I would expect to occur given the circumstances we have faced.

As to the regulatory changes, it is an important question to what extent these changes may have flexibility. It is very hard for me to tell. Many people that we encounter from a business background are quite concerned. It is not uncommon, of course, that when there has been a change for there to be uncertainty about how the new system will work. In some respects, I guess, one would have to say it is as much in the implementation and administration of it as in what the legal provisions themselves say.

Mr CIOBO—Just to flesh that out, what sorts of concerns are being expressed?
Mr Stevens—People I have spoken to are concerned that it will be harder to get productivity gains and harder to contain costs in the future and that the flexibility of the system is not as great as it was. Whether those concerns are fair and valid, whether they turn out to be validated by experience, time will tell. I cannot know yet. I can only record that many people from a business background that I have heard talk about these things do have these concerns. It will be important that the new system is administered and implemented in a careful and flexible way.

Mr CIOBO—You do not really have the luxury, though, of waiting too long to make a determination on that, do you? To tie back to your earlier point about wishing people had moved earlier rather than later, if we are seeing wage-price pressures flowing through as a consequence of re-regulation of the labour market, won’t that mean if you wait too long there are going to be larger increases down the track rather than smaller at the front?

Mr Stevens—It is always the case that if you are getting genuine inflation pressures and you wait longer, you are risking having to do more later. That is true. At this point though, as I say, in aggregate I do not think what we have been able to see in the data as yet is materially different to what we had expected. But there is some uncertainty about how the new world will work, and that is not something that we can really change from where we are sitting.

Mr CIOBO—There is one more point I want to ask about, but I will come back to it later so other committee members can ask questions now.

Dr LEIGH—I have a follow-up question on the labour market flexibility issue. You have spoken about discussions with people in business about this, but if we look, for example, at the effect of legislative changes on hiring intentions do we see anything in the data there when these legislative changes came through?

Mr Stevens—What we have seen on vacancies and so on are that they have gone up. Depending on which measure you use, they have gone up noticeably or on one measure they are actually quite high as a share of the labour force. I would agree that I do not think one can detect in those data nor, obviously, in the employment data themselves at this point in time an adverse impact of these new arrangements. I agree with that. I think the real question is: will there be one? We do not know. I can only record, as I say, that at least a number of people are concerned. That is all one can say at this point, I think.

Mr STEPHEN JONES—You have talked about the perceptions of some business people you talk to about constraints in labour market productivity and capacity arising out of new legislative arrangements. But it is true, is it not, that there is no evidence or any data which proves there is enhanced labour productivity arising out of the legislative changes that were in place between 2004 and 2008?

Mr Stevens—What the data on productivity show overall, I think we would have to say, wouldn’t we, Phil, is that in recent years it has been disappointingly weak, really. We cannot observe what it would have been under another set of arrangements, of course.

Mr STEPHEN JONES—But the point is that there is no evidence that there was enhanced labour market productivity.
Mr Stevens—I think it would be hard to sustain an argument that a particular set of previous arrangements had led to a leap in productivity, based on the aggregate data. I would not want to have to make that argument because the data are not that strong. The people who would defend those arrangements would not defend it on that set of figures, I guess.

Ms O’DWYER—Since we are discussing this topic now I think it is probably appropriate to ask this question. Governor Stevens, you have said it is going to take some time before we see the full impact of the government’s legislative changes in relation to the new workplace laws. How long before we can actually make an assessment and economists can make a judgment on this?

Mr Stevens—I cannot really give you a date. The day before, we will not know, and then on that day we will know—and it will not be like that, as you know. The real test, I suppose, is whether we can go through a period of labour market tightness like we had three years ago and not see a materially more adverse outcome overall for the economy than we had then. That is presumably a reasonable test and it is going to be a few years before we can give you the answer to that.

Ms O’DWYER—Are there any parameters in the Reserve Bank’s economic models that relate to labour market flexibility? Have any of these parameters changed given the new laws that have been introduced?

Mr Stevens—I do not think we have a labour market flexibility parameter per se in models. The way these macro models typically work is you have an unemployment rate or some kind of gap between actual and potential output, something like that, you have some other variables and that drives an inflation outcome. If there were an adverse change to labour market flexibility, then the way that would show up in such a model over time would be that at any given rate of unemployment—assuming that is the correct measure of labour market capacity, which we could argue about—you would get more wage pressure than you otherwise would. That is how it would show up, but it is going to be some years before the modellers would be able to detect that.

Dr Lowe—It is very hard to get a concrete measure of labour market flexibility that you could put into one of these models. So as the Governor says, the main way that changes in labour market flexibility would show would be any change in the relationship between the unemployment rate and wage growth and that takes time.

Mr Stevens—I think people who do cross-country work on labour markets which are not in a time series dimension are trying to explain different average labour market outcomes across countries. They would probably be looking more intently for some kind of summary variable for flexibility. In the work we do, where we are trying to understand the economy’s properties through time, we approach it in different ways.

CHAIR—We have had this discussion on many other occasions. I think comments you made previously were that policymakers need to balance the issue of fairness with flexibility. Is that a statement you still consider to be—
Mr Stevens—It is because my observation at these hearings over more than a decade is that we often come back to this industrial relations issue and—it is an over-simplification to put it this way—there can be a very strong focus on efficiency and total flexibility and so on and there can be a very strong focus on fairness for those who are in work. Of course, fairness for people who are in work can come at the expense of people who might otherwise have been in work but will not be if you raise minimum wages too high or something like that. In the past I have said that it is not my job to work out where the balance on that spectrum is decided; that is your job in the parliament and that is the appropriate place for that decision to be paid taken.

Mr CIOBO—Thank you—you have sparked a vein of inquiry, Governor. With respect to labour market flexibility, and I am trying to ask in aggregate terms, you have commented that what we have seen as an uptick effectively in the utilisation of spare capacity. We have not seen concurrent strong growth with respect to average hours worked.

You may or may not be able to answer this, but I am just interested in whether you believe it is reasonable to conclude that, with evidence showing increased aggregate demand and a new labour market regime imposing significant increases in penalty rates beyond standard working hours, businesses are utilising that spare capacity because of a reluctance to put people on additional hours, given the increased labour market costs associated with that.

Mr Stevens—The argument there would be that instead of increasing the hours of people they have already got they put on new people. Isn’t that how this would have to work?

Mr CIOBO—Would that be perhaps explained by the—

Mr Stevens—I do not know. If labour market rules have changed in a way that makes people less inclined to hire, I would expect them to—all other things being equal—maybe increase the hours of the ones they have before they commit to a whole new employee.

Mr CIOBO—I think you are arguing both sides of the same point.

Mr Stevens—Am I?

Dr Lowe—There have been two things going on over the past year. The employment growth has been extraordinarily strong at over three per cent. So the number of people actually in employment has risen very strongly. Average hours have gone up about half a per cent, but they had fallen by two per cent in the downturn. What is difficult to know is whether we will return to the higher level of average hours that we had before the downturn. If you talk to people, many will say that before the downturn occurred they were working more hours than they really wanted to. That was when the unemployment rate was four per cent and many firms were having trouble getting labour, and people were working more hours than they wanted to. When the downturn came those extra hours were unwound and now they are gradually rising again. But perhaps we will not go back to that very high level of average hours that we were at before, because people felt they were working too much when the unemployment was four per cent.

Mr CIOBO—but from a productive capacity point of view is that not unusual? Surely, there must have been a change. We know from a policy perspective there has been a change which has
seen significant extra costs associated with beyond standing working hour arrangements. Would that help to explain why we are not seeing that increase in the number of average hours worked?

Dr Lowe—I do not think that is the main thing going on here because the transition period for the increase in penalty rates is five years. So it is going to take quite a long time before it has its full effect. I think the main thing is that firms have just been prepared to hire more workers rather than to get their existing workers to work a lot more hours. I think it is testament to the underlying strength of the economy that firms have confidence and they are employing workers. Employment growth has been very strong.

Mr CIOBO—I will just turn to the issue of banking competition again. Further to the Chair’s questions, in household lending we have seen a significant increase not so much in bank lenders versus non-bank lenders but within the bank sector. For example, in September 2007 the big four banks accounted for roughly 68.35 per cent market share. As of September 2010 the big four banks accounted for 80.8 per cent market share. So we have seen considerable uptick in the market share of the big four banks.

In large part, that is a consequence of the acquisition of St George and Bankwest. I realise that some may say that the Reserve Bank has a bias towards seeing the banking sector being profitable and stable but, from a consumer point of view, is this a good outcome? What measures should be taken to improve the level of competition in the banking sector—but not at the risk of stability, of course? I am interested in your direction on that.

Mr Stevens—I might get Guy to come in on this in a moment if he wishes to. Let me begin with one observation about that period when the share went up. When we think back to that period, largely what happened is that the ability of some of the other lenders to keep funding what they were doing, of course, was greatly curtailed by the disruptions in markets. Lenders which were not as exposed to that actually, I think, stepped into the gap and increased their lending, which probably, I think, was a stabilising thing for the economy. So initially you actually want that change in market share if the other ones whose share is shrinking just cannot do the lending, which was part of the story there. So you want someone else to take that over at least for a while. That was stabilising. I agree that you want to see a degree of competition here on average over time. I think it is the case that the share of majors in new lending has actually been falling for a while, isn’t it, Guy?

Dr Debelle—Yes, for about six months now the lending share of the major banks has come down from the levels that you were talking about.

Mr Stevens—So it is still higher than it used to be, but the peak is behind us and it has come down since then. I do not know if that will keep happening, but there has at least been some reversal of that market share change to date.

Mr CIOBO—I had the September 2010 figure at 80.8 per cent. You are saying it was actually higher than that?

Dr Debelle—No, the numbers you are referring to are the stock of lending, and that is right, but then if you look at the new loans being issued at the moment then the number has come down.
Mr CIOBO—Sure, but you are saying it has come down in the last six months, so it was higher than the September figure that I had, given that that was only a couple of months ago.

Dr Debelle—No, it had been up around that level and it has just started to come down very recently by a few percentage points.

Mr CIOBO—in the last six months or in the last couple of months?

Dr Debelle—Let me be precise about this. On the data that I have, it peaked at about the number you said. It was about 80.5; it peaked a little bit higher than that—less than a percentage point higher than that—a few months prior to that, and it has come down in the subsequent couple of months.

Mr Stevens—they are flow figures. The stock figures, of course, will follow that with a lag.

Mr CIOBO—On this issue of competition, according to the RBA’s data the cost of variable-rate small business loans secured by residential property was nearly identical to the cost of a home loan for 11 years before the GFC hit. Specifically, small business paid on average only 0.22 per cent more than the standard variable rate home loan. During the GFC, this spread blew out by 6.8 times, to 1½ per cent, and today these small businesses are still paying 1.2 per cent more than residential borrowers according to the RBA’s data. I am interested to know, from an RBA perspective, whether Australian banks have got the pricing of small business loans wrong for the last 11 years and the new policy or the new pricing as imposed today is correct or whether this new-found concentration of lending by the major banks is effectively price-gouging the small business sector.

Mr Stevens—I think it is probably reasonable to conclude that, given that we know that risk generally around the world was underpriced for at least a few years prior to the events of 2007 and 2008, there was always going to be, even in a highly competitive market, some repricing of risks. Small business lending is hard to do. It does have a materially higher degree of risk than just lending on the average housing loan. I would not want to be drawn too far on whether the pricing is exactly right now. I think it is understandable that there has been a change in the pricing in the direction that we have seen. My guess is that, as time goes by, we will see that pricing start to tighten a little bit, but that will be a slow process.

CHAIR—we might now adjourn, have a short break and come back at 11 o’clock.

Proceedings suspended from 10.43 am to 10.59 am

Ms OWENS—we have focused on our banks a lot and I would like to stay there for a moment. When the global financial crisis came along our banks of course held very well relative to the rest of the world. I am aware that in the G20 there has been some work done by the Reserve Bank and the government on the international regulatory framework for banks. How is that going and how will our banks be able to respond to that?

Mr Stevens—There has been a lot of work and there have been a lot of meetings in far away places, unfortunately, this year. The thrust of the international changes has a few elements. At the global level, there will be more capital, obviously. Many banks, particularly the very big globally

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active banks, were too leveraged, so they needed more capital. There will be higher quality capital, so less in the way of things that do not actually bear loss in a time of stress and more genuine, real, common shareholder equity type capital that is loss bearing. There will be an aggregate leverage ratio in addition to the Basel risk-weighted capital standards. Our view has been that that is probably not really necessary at all in our case, but in some countries it is regarded as important so there will be something like that. There will be liquidity standards which are designed to prompt institutions to manage their liquidity, particularly their funding liquidity, more carefully and more actively than they were doing.

In relation to the capital standards, these are going to be phased in over quite a long time—in some cases it will be 2019 before they are fully implemented. I do not think our banks will have very much trouble accumulating the additional capital they will need. They are quite close to the new requirements already in most cases. I might say that APRA has had a fairly conservative way of approaching these things all along. Our banks have tended to complain over the years that, if only APRA would measure capital the way the British do, we would all look better. But what is happening is that the way others are thinking about this is shifting closer to where APRA has been all along. So they will not have too much trouble there.

The area where there is an issue is the liquidity standards. I think we might have covered this before. Basically, the new standards require banks to hold much more in the way of government securities as a high-quality liquidity buffer, but there just is not enough government debt in Australia for them to do that. We have been working with the Basel Committee on Banking Supervision on how to meet the standard. Some commentary in the press has been along the lines of there being an exemption given. There will not be an exemption. Our system will meet the standard, but it will meet it in a different way to the average country in recognition of the fact that there just is not enough government debt in existence to meet it the normal way. I cannot say too much more about that right now, because this is still under discussion and is not final, but I think we will be able to come to a way of meeting the standard in a fashion that makes sense for Australia.

On top of that is the work that the Financial Stability Board is doing on so-called SIFIs—systemically important financial institutions—particularly the global ones. That work is on even higher standards for those 25 or so major banks. If this project proceeds in the way I hope it will and sensibly, then our banks, which are not global SIFIs, they are systemic to us but not to others, ought not to be captured there. APRA and we give a lot of thought to the issues that come with systemic importance, but I do not think it makes sense for our institutions to be gathered up into this global project, in which you have Citibank and that kind of very, very large entity.

There is quite a lot of work going on. There was a report to the G20 leaders on the Basel proposals. There was also a report at the meeting the other week in Seoul from the Financial Stability Board. So a lot of progress has been made. There is still a fair bit of work to be done over the next couple of years.

Ms OWENS—Coming back to local matters, in a number of meetings that I have attended with you I have tried to tease out what ‘normal’ was in terms of cash rates. Up until now, if my memory is correct, you have said something like, ‘A bit higher than it is now.’ I notice today that in your paper you actually specify what you think ‘normal’ is. I am wondering what the difference is?
Mr Stevens—For some time, of course, we had very low rates. We felt it was important that people understood there was a reason they were there, but when the reason had passed then the rates would be normal rather than well below normal. The use of the word ‘normal’ is shorthand, really, for saying that, if you look over the period where we have had low inflation—which is about 17 years long now—there was an average set of interest rates that seemed to be consistent with that average low inflation rate. On the cash rate that would have probably been in the fives, or maybe even a tad more. What we are saying today is that, because the margin in the cash rates and the rates people actually borrow at has risen, we recalibrate what we think of as normal, at least while that widening remains in place. I would have said that the 4.5 cash rate, which is clearly well below what was normal before, is for all intents and purposes normal in the world we are in now where the margins have widened because it delivered a mortgage rate or a business loan rate that was pretty much the average of the past 15 years. As of the last decision, we have moved above that a bit now. I think we would have to say that, particularly given the increase in loan rates is a bit higher than what we did, monetary policy settings are a bit above normal now. As I say, that is appropriate for the circumstances we think the economy is going to face.

Ms OWENS—The withdrawal of the stimulus is going in the same direction, from what I can gather.

Mr Stevens—The fiscal stimulus, yes.

Ms OWENS—It is about a one per cent contraction over the next financial year, I think, according to MYEFO. In my electorate I am lucky enough to know how many people were employed on the stimulus because I have all the construction companies. Nearly three per cent of my workforce was employed at the peak on the stimulus projects. That, of course, will wind back over the next year. How confident are you that the rest of the economy is actually going to soak up people as they come off the stimulus paid employment?

Mr Stevens—That is a key question: the so-called handover from the effect of public spending programs to the private sector. We cannot be certain but the community’s income is rising, the terms of trade rise is a very large income rise and that flows to a whole group of different sectors of the economy, but household income will benefit from that. Employment has been rising so income benefits from that. Consumer spending is more careful and cautious now than it was and retailers will say that. Overall consumption is still growing, probably a little bit below average, but still rising. I could get Phil to elaborate here. The stated investment plans that firms give to the ABS, which then get published, and we had an update on this yesterday, still remain very strong. I think we apply some discount actually to some of this because we do a lot of liaison with the resource sectors to try to get a feeling for how quickly or how slowly many of these projects will go ahead. So we apply a certain, if you like, scepticism to some of the stated intentions.

Even with that, it would appear that over the next year or two a very significant build-up in business investment, particularly in the resource sector, though probably not only there, is in prospect. We are getting, we think, the handover from the temporary public stimulus to the private. Whether that will work perfectly neatly in your electorate, of course, I cannot be quite so sure of. At an aggregate level, this was one of the uncertainties that we faced all year—will this
handover occur on schedule or won’t it? We are still not 100 per cent sure, but we think that it is probably going to occur.

**Dr Lowe**—It has been a key element of our story for the economy that this handover is going to occur. I think we can start to see some of the elements of that actually taking place now. In the capital expenditure data that was released just a couple of days ago we saw a very big increase in capital spending in the resource sector. When firms were asked about the amount of spending they are going to do over this financial year, if you take that literally, it says capital spending is going to be up probably more than 20 per cent over this financial year. As the governor said, when we put together our forecast, we have discounted that quite a lot because we think probably that it is too optimistic. Even discounting it quite a lot we get a very big rise in investment spending. You can start to see it in capital goods imports, which had been soft earlier in the year but are just starting to rise again in ordering for plant and equipment. It looks like it has reached the trough and has started to turn around. There is still uncertainty there, but I have to say that, relative to a few months ago, there is a bit less uncertainty now than we thought there may have been. You have seen the large coal seam methane gas project announced. I think over the next year you will see further investment in that area. We talk to a lot of the resource companies and our sense is that the pick-up in capital expenditure that they are reporting in the ABS data is, in fact, going to occur. Whether it occurs exactly on that timetable is hard to tell, but the general story is one where the investment picks up strongly.

**Ms OWENS**—I would appreciate if you studied just my electorate in these analyses; that would be nice. The Reserve Bank always gets the trigger-happy criticism when it increases interest rates. You might tell me whether you have ever got that for lowering them, but that is not the question. I am interested in the counterintuitive argument, which we never get to see. We only get to see what happens when you do what you do and not what may have happened if you did it later.

**Mr Stevens**—Counterfactual.

**Ms OWENS**—Yes, the counterfactual, that is right. What could have been the outcome if you actually had delayed that interest rate rise and you turned out to have been right to do it then?

**Mr Stevens**—The truth is we could have delayed a month until December and then have done it without maybe making a material difference to the course of the economy. It is very hard to say that it would. The problem is that any month you can say, ‘Let’s just wait a bit longer.’ You kept waiting and then eventually what typically tended to emerge when that was the case in the past was that you thought, ‘Now we have to get motoring and catch up.’ I think it is better really to move in a reasonably timely fashion to a point where you might be able to rest for a while. That is a better position to be in. As I said earlier, yes, we will be criticised for being trigger-happy. We do get criticisms for cutting rates, by the way, but from a different group. As you know the number of people who do not have a mortgage outnumbers those who do by two to one. This is a fact not commonly reported, but it is a fact. There are people who write in complaining about rates going down. It just does not make the news as much.

There is usually criticism for rates rising but all I can say is that, as mentioned earlier, having observed this or having taken part in it for a long time, I do not think I can recall too many occasions when with an early rise we looked back and thought we wished we had not done it.
can think of occasions when we wished we had moved more quickly or sooner, and I think there 
have probably been occasions when you can look back and wish you might have started coming 
down sooner. I think we got the down in this past episode pretty early and that worked quite 
well. It is easy for the process to have a lot of inertia, ‘Let’s just get a bit surer before we do 
anything.’ The problem with doing that is that once you are sure, you are late, almost certainly.

Ms OWENS—You said it is better if you can get to a position where you can hold for a while. Are you saying that it is better for a person with a mortgage that we do that?

Mr Stevens—I would guess so because, if the option is you go months and months warning 
people that it is going to happen, plenty of people would probably say, ‘Can’t you just do it so 
you can tell me “that’s it”’. Of course, we can never quite say that there definitely will not be 
any more but I think a lot of people probably would rather be in the position of knowing where 
they stand, at least for a period of time, than having the continual anxiety.

Ms OWENS—I will ask about the old ATM fees—the Reserve Bank has done quite a bit of 
work over that and it has been a while now—how is that panning out?

Mr Stevens—We are mostly happy with how this has turned out. As you know, it was about 
18 months ago—a little more—that we introduced some reforms which abolished interchange 
fees. The reforms required disclosure of what the fee was going to be, if you are going to pay 
one, at the time you are about to pay it as opposed to a month later finding on your bank 
statement that you have paid a fee. We felt that it was important that the person who owned the 
machine be able to set the fee. It is their machine, after all.

As a response to those sets of changes nobody pays a fee for using their own bank’s ATM; just 
about everybody has access to a reasonably substantial network that will give them a fee-free 
withdrawal; people have responded to knowing what the foreign fee is going to be by changing 
their behaviour and there has been a marked increase in the proportion of transactions done at 
own-bank and a corresponding fall in transactions at foreign machines; the aggregate saving in 
fees resulting from that is about $120 million a year across the community, and there does 
appear to have been an increase in the number of ATMs available in total.

I do not think we can claim that that is certainly a result of the reforms because that might 
have happened anyway, but where we were heading in the old world was that we were going to 
start to see some constraint on the deployment of machines by the independent deployers at 
some point because they were not going to be able to cover the costs appropriately because the 
bank actually was setting the price they could charge, which I do not think was the right thing.

Nearly two years on from those changes we see that just about everyone can get fee-free ATM 
withdrawals; we see the community is paying $120 million a year less in ATM withdrawal fees 
than they were; and we see, I think it is, about six per cent more machines in existence across the 
country than there were then. I think that is a pretty reasonable outcome.

Ms OWENS—Thank you. One more question: the circumstances in Ireland and Europe are 
obviously still very volatile. How uncertain do you think it is and what are the possible 
consequences here?
Mr Stevens—It remains very uncertain. The Irish government has now approached European partners and the IMF for assistance. They will have to do more budget cuts as part of that, and they have already done a lot. They got into this position in large part because their banking system grew very large relative to their economy. It was linked to commercial property in a leveraged fashion. It is so often the case that financial crises end up coming from property exposures, frankly. Once you are in that position it is a very hard task to get out.

The real question in Europe, of course, is not really just about Ireland per se, just as it was not really about Greece per se—they are both quite small countries. The question that people focus on is: how similar are the situations that might be faced by other countries, some of which are much larger, and what would happen if they got into trouble and so on? Our European colleagues have to try to stabilise this and they have to do it in a way which supports confidence in a number of other countries in that region—we know who they are—and it is a very difficult task. My assumption is that for several years we will see periodic flare-ups of anxiety in Europe as they try to work through this, but they have to strengthen their banks and their government finances, which in many cases in Europe were already not very good before all this began, let alone now. They have to try to rectify that but also keep economic recovery going. That is a pretty tall order.

So we will see, I think, continued uncertainty about how all this will play out. My guess, as I say, is that we will see repeat episodes of anxiety every so often for a few years. What that means is that, for us, we balance the possibility that things could go pear-shaped in Europe—they may or may not; we will not know for sure for quite some time. I think in the US things are probably going to be okay, but they are not that strong. Of course, then we have Asia, and as every year it goes by it is clearer and clearer that the centre of gravity in the world economy is shifting there and we are very plugged into that, so we have to manage that. It is a complicated picture.

Ms O’Dwyer—Governor, this is my first time at committee, so I will probably jump around just a little with some of the questions I am going to ask. I want to return to the question of the cash rate first and foremost. The consensus view of a number of economists is that the cash rate by 2011 will probably be around 5.5 per cent. I suppose that implies another three RBA rate hikes. Can you tell us whether this consensus is broadly in line with the RBA’s central case?

Mr Stevens—What we will find is that the consensus can shift around a bit. It is only a few months ago that some market pricing suggested that the cash rate might actually fall before the end of this year, which, of course, it did not. I might ask Dr Debelle to indicate where the market pricing is just now, which is at least one benchmark to ground this discussion.

Dr Debelle—the market pricing only has the cash rate rising to five per cent by the middle of next year and rising maybe a little beyond that but not a lot, so not quite as much as the economists you are talking about suggest.

Mr Stevens—Some economists have it going up that much; some do not. I am not sure myself, to be frank, where we are going to be in a year’s time—you cannot be. It was a reasonable statement a few months back that, if we went into the period we thought we were going to go into, we were going to need, as I said earlier, some degree of restraint. We may need some more than we have at the moment at some point, but at this stage the expectations are for
only fairly gradual and not very close together increases. At this point, I certainly do not want to
steer people away from that today. I do not think there would be enough information on which to
do that. But these things are inherently uncertain, and I am supposed to be circumspect anyway
in what I say. You will notice that an interesting feature of the debate is that the people who have
most to do with actually making the decision are the ones who try to speak of least about it.

Ms O'DWYER—Our task is to draw you out!

Mr Stevens—Indeed it is—and my task is to try not to be drawn too much!

Ms O'DWYER—Indeed. I will change tack to give you some respite. Australian taxpayers
have furnished private banks with $850 billion worth of guarantees, and the RBA has provided
them with unprecedented liquidity facilities. Can you tell us whether this raises the risk of moral
hazard in Australia, and can you explain for the benefit of the committee your understanding of
‘moral hazard’.

Mr Stevens—It is a good question because it goes to the future as well as the past and the
present. Let me see if I can set out a few facts. The $850 billion you refer to, I take it that is
deposits. The government made available a guarantee for wholesale funding, which was of
course priced. The government took some risk here, but it was very well paid to take that risk. It
is earning about $1 billion a year in fees. Sometimes we hear people say, ‘The government didn’t
give it. It sold a guarantee, and at quite a nice price.’ That is closed and the stock of guaranteed
liabilities which got to around $170 billion or $180 billion is actually starting to come down now
very slowly. It will come down more quickly as the guaranteed debt matures over the next
several years. It is the same for the state governments. That is about to close, if it has not already.
I do not think that will be disruptive.

The remaining part, as you say, is the guarantee on deposits of up to $1 million. One of the
things that does have to be done in the next six months or so is for officials—and we are
working with the Treasury and the Council of Financial Regulators and others—to try to figure
out what the world should look like after that guarantee finishes, which is at the end of October
next year. It would be improper to speculate too much, but the size of the cap is obviously an
issue that has to be considered carefully.

On ‘moral hazard’, there is a moral hazard everywhere in the world because governments and
central banks did extraordinary things. Some of the things we did were unprecedented for us but
by the standards of what some other countries did were pretty mild. So there is a huge moral
hazard because governments and central banks did these things. They had to be done, because
the system faced a catastrophe in the absence of these measures. But them having been done, and
even though we are withdrawing them, the issue we will face—and this is what you were getting
at, I guess—next time there is some pressure is whether there will be another guarantee. My very
firm view is that we ought to try to get to a position where at that time, whenever that day
comes—hopefully, not soon—our government will be in a position to say, ‘No, we are not going
to give a guarantee that the system will be able to cope with that.’ I think we are much closer to
being able to say that than most countries, but we still have some work to do to get a permanent
set of arrangements, particularly for deposits, which can stand the test of time. That is on our
agenda at the moment and for the early part of next year. I expect that at future meetings we will
probably come back to that. It is a very important question.
This is why, to hark back to the questions Ms Owens asked about the global regulatory work that is being done, people are very conscious of this, very conscious of the need to try to lessen the moral hazards surrounding some of these very big global banks by making them safer, less likely to fail and easier to resolve if they do fail and so on. It is very much, though, still a work in progress. That is the best I can tell you at this point.

Ms O’DWYER—Governor, would you consider that these guarantees are contingent liabilities—that they increase the risk profile of the Commonwealth prior to its position pre the crisis?

Mr Stevens—We are getting into areas where it is very difficult to talk about this publicly, so I will be a little bit guarded. But, from a strictly accounting point of view, they have taken on a contingent liability that they did not have before. What is the probability that you would actually have to make good on the entire deposit base of the banking system? It is extremely low. So, if you were trying to measure this obligation, it would be the size of that times some probability of having to make good on that, and that is very low number. I think you would also, to be honest, have to, in the back of your mind, pose the question: in the previous world, without this guarantee, would a government stand by to let the system collapse and do nothing? I cannot think that they would. There was always some unspoken, unquantified support. But it is a very interesting question: should that be made explicit and priced or shouldn’t it? That is one of the issues that I think we will probably have to have a discussion about, but today is probably not quite the moment.

Ms O’DWYER—That leads pretty nicely into my next question, which is: can you tell us whether there is a risk in the fact that Australia has four ‘too big to fail’ banks that effectively benefit from implicit taxpayer guarantees.

Mr Stevens—we have four large institutions, but the number in a crisis is not necessarily limited to four because in crisis conditions, if people are panicked enough, even a smaller entity can end up being quite disruptive if it is in distress. The other side of that, of course, is that those institutions are supervised very intensively by the supervisor, who is quite prepared on occasion—and has done so—to require banks to do this or that additional thing over the minimum, if they think that is appropriate from an individual risk or even a systemic risk point of view. But this is the nature of banks. It is a tricky area because banking just is not like any other business. A bank failure, even for a not-so-big bank, is not like the failure of any other business, where someone else comes in, buys the assets, employs the people and everything keeps going. It is not that simple in banking, which is why we have regulation that is much more intrusive on a bank than it is on your average industrial company. It is for that reason. It is why there is this very difficult, delicate balance with the problem of moral hazard. To make moral hazard go away entirely is probably impossible. It is a tricky area.

Ms O’DWYER—I want to refer to the new statement on the conduct of monetary policy that was signed in September 2010. As I understand it, the RBA added the following new text, which has not appeared in previous statements since the first one was signed by the former Treasurer. That statement is:

The Reserve Bank’s mandate to uphold financial stability does not equate to a guarantee of solvency for financial institutions, and the Bank does not see its balance sheet as being available to support insolvent institutions.
As you of course know, the RBA has a responsibility to serve as a lender of last resort to deposit-taking institutions that are adversely affected by these liquidity shocks, as it did during the global financial crisis. If a bank can no longer fund itself because of an external shock and the RBA is the only counterpart in the world willing to lend to it, how can this not represent the RBA using its balance sheet to support insolvent institutions?

Mr Stevens—The distinction, though, is between illiquid and insolvent, so, in the classic central banking setting, if an institution is illiquid but it does have assets it can pledge as collateral the central bank, on the assumption that it has some reasonable look at the quality of those assets, can lend against them at an appropriate rate of interest. This is Bagehot’s classic— in a liquidity crunch, lend freely at a high rate to sound banks. We would do that. Nothing in this statement on the conduct of monetary policy changes that fact. The Reserve Bank will always play the role of provider of liquidity against collateral at an appropriate interest rate.

The statement about not seeing the balance sheet as being available to support an insolvent institution is making a different point. It is saying that we do not regard it as proper, and no central bank would, for a bank which is actually insolvent to be bailed out by the taxpayer through us. If it is going to be bailed out by the taxpayer, the government should make that decision and should fund it itself. We would probably have some role in facilitating that in the event it occurred, but the government would have the credit risk, not the central bank. I think that would be, in central banking circles around the world, the way all central banks would think about it. So our role is in liquidity and we will always be prepared to do the right thing there by the system and by participants in the system in a crisis, and we have done that and we basically doubled our balance sheet in 2008-09, for a brief period, for that very purpose. As to the financial rescue of an institution which is not solvent, there may or may not be a public policy case to do that but that is a government call. We would obviously give them our views if they asked, but that would be their call, I think quite properly.

Ms O’Dwyer—The RBA has repeatedly communicated its concern that the Australian economy is operating near full capacity, and given expected above-trend growth over the next one to two years faces the spectre of inflation pressures. In March of this year Assistant Governor Dr Philip Lowe gave a speech in which he argued that, for Australia, the main task is to expand the supply side of the economy so that demand can grow solidly without causing inflation to rise. Can you shed some light on the key supply side deficiencies that the RBA has identified and is concerned about?

Mr Stevens—Seeing as you have referred to Dr Lowe’s speech, I will pass to him to see whether he wants to shed any further light on it.

Dr Lowe—The point I was trying to make here was that over the medium term growth in our living standards is going to be determined by productivity growth. We have been through a period over the last decade where that has not been the case because the growth in our living standards has actually come primarily because of the increase in the terms of trade, meaning that we are getting paid more for the goods we are selling overseas. If you look forward, we cannot expect the terms of trade to keep rising and we will inevitably go back to a period where growth in our living standards is going to be determined by productivity growth, or, to put it another way, expansion of the supply side. We are not the experts on how to do that. There are obviously areas, in transport, in education, in health, where things can be done to improve the ability of the
economy to produce goods and services efficiently. It is not our core area of competency but it is an area that needs to be looked at very carefully. I am not in a position to give you specific instances where reforms would make a big difference to particular sectors.

Ms O’Dwyer—You say it is not your core area of expertise, but presumably you have some idea of some of the major supply side constraints that you are thinking about to have identified this as an issue in terms of infrastructure?

Dr Lowe—There is a lot of infrastructure investment going on in the resources sector. Australia’s capital stock at the moment is probably rising at an annual rate of around five per cent. That is very, very fast—around the fastest rate in 50 years. Most of that at the moment is in the private sector, and there is a role for the public sector to expand infrastructure investment alongside the private sector investment. But, as I said, I am not in a position to say that this particular project or that one would make a difference. If the private sector investment is going to be as efficient as it can be, then there needs to be public sector investment in some cases to go along with that. But beyond that I cannot really answer or give you specific instances.

Ms O’Dwyer—If the private sector is not willing to fund some projects that would be related to this and 100 per cent of the equity risk is to be borne by the Australian taxpayer, can you explain what economists mean when they talk about the opportunity cost of capital?

Mr Stevens—The opportunity cost of capital would be, ‘I use it in area A; I can’t use it in area B,’ assuming that the quantity of capital available is finite. You have to be a little careful there, because there is a global supply of capital that is very big and the real question is how well we use it. This is really making very general points, but we are probably going to need more investment in electricity, are we not, over the years ahead, and water? Some of that is being done. There is a fair bit of urban infrastructure that would be desirable, as anybody who lives in any of our major east coast cities—or west coast, for that matter—would think. All of that has to be done, but we have to try to do that at the same time as we build more houses and build more mines. So it is going to be a tall order, I think, to fit all this in without overheating things, if you think about it that way. That is part of the reason that I suspect a little more caution on consumption—which I think we do see amongst households, anyway, at the moment—is probably no bad thing if we are going to fit all these other things in as well.

Ms O’Dwyer—This is my final question, because I realise I am running out of time. I noticed you did not actually mention $27 billion of taxpayer capital and another $10 billion of taxpayer debt issuance on the National Broadband Network. So I suppose my question is: is there a risk if the government ends up allocating vast amounts of taxpayer capital to projects that the private sector has rejected which do not work materially to improve the supply side of the Australian economy? What hurdles should these projects face to satisfy us that they warrant the commitment of taxpayer dollars?

Mr Stevens—I do not want to get into the NBN in any detail. It is an area that, to use Phil’s words, is outside our core area of expertise. As a general proposition, there probably are some projects that the private sector will not fund that still ought to be done. Whether this is one of them would be another question. But I think you can imagine some projects that the private sector just does not feel it can take the risk on but on which the public sector—which, after all, has a stronger balance sheet than anyone else—might on some occasions be able to accept that
risk. But there ought to be, of course, a proper cost-benefit analysis of that case in those instances. It is not unreasonable to expect that more interconnectivity around the country can be a benefit to productivity—that is a reasonable claim, it seems to me—but, as I have said on one or two other occasions, much hinges on how much you pay to do it and how efficiently it is done. But that is not for me to adjudicate on in that particular case. Much as I am sure you would like me to, I don’t think I can.

Dr LEIGH—Thank you very much for coming along today. As an economist I feel a bit like a kid in a candy shop, getting the chance to speak to three of Australia’s leading macroeconomists. As Ms O’Dwyer said, forgive me if I range over a variety of different topics. At the outset, I want to ask you how you would characterise Australia’s macroeconomic position relative to that of other developed countries, particularly in areas such as unemployment and debt levels.

Mr Stevens—We had a modest downturn. The chart that I have in mind is the one from the speech in Shepparton, I think. It showed how GDP fell less here, very temporarily, and we went back to growth more quickly than many countries with which we compare. So we had a small downturn. Many countries have had their worst recession since World War II, whereas we probably had our smallest—if we would call it a recession. That is good. The unemployment rate peaked below six per cent when many of us, including me, thought it would go materially higher than that. That has to be a good outcome, even though it means, as Mr Ciobo said earlier, that we will start the upswing with less spare capacity. That is kind of a good thing, in the broader sense. It just takes careful management. That is also good.

Our public debt is higher than it was but it is low by the standards of developed countries, to the point where, in meeting Basel liquidity requirements, it is too low—from that very narrow perspective—so we will work around that another way. So that is good. Private debt, on the other hand, is considerably higher than in some countries. It is probably in the pack for English-speaking countries with which we would compare ourselves, but some of those have had a pretty bad time lately, so we would not necessarily want to stand out too much more on that score. That is why I think that the more modest growth of housing credit that we see now is probably sufficient for the economy’s needs, but we do not want to see that ratio of debt to income keep going up the way it was. So that is a thing to watch. But, as I have said to many people, I sit around the table with my counterparts from 40 or 50 countries a number of times a year, and I have not yet found one whom I would want to swap places with. I would rather have our problems—and we have some—than theirs.

Dr LEIGH—Given that Australia’s public debt levels, as you said, make it difficult for us to meet the Basel liquidity standards, do you find it a little ironic that some in public commentary are arguing that Australia has too much government debt?

Mr Stevens—Things are said in political debate, and I have no particular comment on the specific things that are said. We do not have a problem here of public debt sustainability. The fiscal issues that are relevant are the ones that were talked about earlier, such as the effects on demand and so on. I have never felt in recent years that the size of the public debt that we have outstanding is a material problem for the country.
Dr LEIGH—Turning from debt to unemployment, what are your views on the benefits for long-term growth of Australia’s having avoided a recession in the last term? I am thinking particularly of the issues of hysteresis around the 1980s and 1990s recessions.

Mr Stevens—The hysteresis effect, yes.

Dr LEIGH—It seemed, at least to me as a school leaver in the early 1990s, that the damage that was done was quite long lasting.

Mr Stevens—The pattern on unemployment, as you know, is that it typically goes up very quickly. It takes a year to rise four percentage points in a recession and then it takes a multiple number of years to return to where it was. This is an issue they face in the US now. So I think that is good. I think it is inevitable that there are business cycles and that we will have recessions in the future. I cannot tell you when, but we will come. But if they can be small ones I think that is very much to our advantage in a long-term prosperity and growth sense.

This episode was a little bit bigger than the one in 2001 but it was nothing like as big as 1990, which at one stage we feared it would be. It turned out nothing like that bad. That is very much to our advantage in a whole host of ways that we cannot actually measure by macroeconomic statistics. I fully agree with that. The question is how you keep recessions small in the future, because we will have them. How do we give ourselves the best chance of them being short and shallow? I think the answer is to keep the excesses and the preceding build-up small.

Dr LEIGH—I will turn to banking. Do you think there is a trade-off between competition in the banking sector and system stability?

Mr Stevens—At one level there probably is, but I will articulate that a little more. Like I was saying before, banking is not just any other business. In many areas it is probably the case that more competition is always better for consumers, but in banking more competition is good to a point but beyond a point more competition is not good, because the bankers can be led to do things that ultimately cause a lot of subsequent damage. I think we have to understand that. That is not to say that the current amount of competition we see in any particular market is necessarily enough, but there is a point beyond which extreme competition in lending money leads to problems.

That is actually the background to why, after the Great Depression, there was so much more regulation brought in. A lot of that regulation was designed to prevent competition from going too far, frankly. That is the way people thought then. Of course, we probably overdid regulation historically and had to come back to letting there be some more competition. I think to a point that was good. But there is a kind of point somewhere beyond which the competition pushes down lending standards and ends up lending money to people who really should not get it. That is not a good thing.

Dr LEIGH—Over the last six months or so, have we seen an increase in the banks’ cost of funds?

Mr Stevens—We have; part of that increase in the cost of funds was because we did it.
Dr LEIGH—Aside from that?

Mr Stevens—Maybe I will get Guy to respond. This is very hard to track month-by-month. We do fairly high-level simple estimates of it.

Dr Debelle—We talked a bit about this in the most recent board minutes and in the most recent statement on monetary policy, so hopefully I am just going to repeat what we said there. Basically, different parts of the banks’ funding have been moving in different directions. As has been noted on a number of occasions, they are rolling off some of their longer term debt; they are rolling off some of the stuff they funded pre-crisis, at much lower spreads, into higher spreads. That is an ongoing process that has still not finished and has been going on over the past six months, as it had been previously. That part of their funding is still going up. On the other hand, their shorter term wholesale funding has probably been broadly sideways, maybe even marginally down, over the period you are talking about. Deposits are the hardest part for us to keep a good track on, but broadly speaking I would say that deposits have probably gone sideways over the last six months.

A lot of this depends on when your starting point is, but if you want to narrow it down to over the past six months or so, the longer term stuff has been going up, the shorter term stuff has been flattish or maybe slightly down, and deposits are probably broadly sideways. Going back to a question the Chair asked earlier, the banks have still been shifting their composition of funding—as has been said, not necessarily willingly—towards those more expensive forms of funding as well.

Dr LEIGH—Governor, in an earlier answer to one of my colleagues you drew attention to the long-run drop in the net interest margin from 2000 to 2004—there is a clear chart on that on, I think, page 42 of the statement on monetary policy. What can we learn from that experience? You said something to the chair about competition and efficiency, but could I draw you out a little on that?

Mr Stevens—The trend actually is a much longer term one than that. It dates from probably 1990 or so. The period since 2006 or 2007 has seen some ups and downs but probably not a great deal of net change. If we think back to what was happening in that world—from about 1990 on—you had the advent of competitors in the mortgage market who saw the niche to come in and say, ‘I can fund myself wholesale at this rate, put a spread on, and out-compete the banks.’ It was the Aussie Home Loans type story. That did pull down those margins and so increased competition. The banks did a lot of work on containing their costs and a lot of that was unpopular because it involved closing branches in many places around the country to save costs. So that contributed, as did other discipline. That is the way the banks were able to keep pace with the competition and still earn the profits that their shareholders wanted. There were all those forces going on and, by and large, that amounted to improved efficiency of the financial system, better availability of credit, lower spreads—the spread is essentially the price the community pays for intermediation services and that price came down over many years as the system became more efficient and that is a good thing.

In more recent years some of the things which made part of that competitive dynamic possible have not been there. The wholesale funding has been more expensive and less available. That has been a change latterly in that trend that has probably stopped it going further but there is a
Dr LEIGH—In thinking about the period over the most recent crisis what role did the government’s $16 billion injection into the residential mortgage-backed securities market play in improving the quality of that market and helping those lenders recover?

Mr Stevens—That has been a source of demand for those particular securities at a time when the mortgage backed security globally as a concept has had a fair bit of brand damage as a result of the things that happened, not here but in America. Many of the sources of demand for those products, particularly the kind of foreign special purpose vehicles, conduits, and so on, have disappeared and they are not coming back. Among the remaining potential investors, mortgages just seem to people to be more risky than they used to be; therefore, these securities price at a higher yield. The AOFM purchases have helped to be a source of demand. Guy, can you talk a little bit about the magnitudes and pricing and how the market is travelling?

Dr Debelle—Yes. I am going to talk about this next Tuesday but the AOFM has bought about one-quarter of the mortgage backed securities that have been issued over the past year or so. Its purchases have amounted to about that. If you think about where the flow of mortgage backed securities are relative to the flow of new housing credit because, as Glenn has remarked earlier, there is less credit, households are borrowing less for housing than they did prior to the crisis—in a growth sense at least.

Where the market is now, and the number of mortgage backed securities being issued, is not far away from maintaining its share of the market—it has fallen to about 10 per cent of the market from some number north of 20 prior to the crisis. As has been said, the market pricing has widened on these things considerably. The AOFM through its purchases, particularly since May, has contributed to some narrowing in the cost of issuing those securities for smaller lenders. So it has forced the price a little bit lower than maybe where the market would otherwise price. It is still buying these securities, which is going to generate the government a decent rate of return, but it has provided some support to those. I personally think the market is showing some signs of generating some ability to be self-sustaining again.

Dr LEIGH—Thank you. To use the analogy I began with, I have been told I can have two more candies and then I have to leave the store. There has been an interesting chart used in several speeches and documents put out by the bank. Governor, that is the one relating to steel production intensity and economic development tracking the trajectory of the US and Japan and their putting on India and China. Can you talk about the implications of that chart for Australia’s terms of trade?

Mr Stevens—As I said in the opening remarks, a quite important feature of the global environment is where some of our key customers for resource products have been growing and growing in a steel-intensive environment. I think it would be the case that even if China’s steel intensity stays where it is now—it does not have to increase—but the GDP keeps increasing at eight per cent a year, which, as far as I can see, is what they are trying to achieve, there is a fairly robust demand in growth from them for the inputs. We will not supply all that growth, of course, but we will supply some. Then probably India’s steel intensity would have some way to rise yet.
Dr Lowe—India’s steel intensity is very low. The big picture here is that over the past decade and a half, 300 million people in China have moved from the rural areas to the cities. When they live in cities they live in apartments, apartments require steel and steel requires iron ore. That is why the global price of iron ore is so high because the demand for steel in China as they urbanise and industrialise is very high. India is just starting on that process but over the next 20 years, I do not think it is unreasonable to expect 100 million or 200 million people in India also to move from rural areas to living in city apartments. They are going to require steel as well. This incredible growth in demand for steel is really underpinning the very high level of terms of trade that the Governor spoke about at the beginning. I think it is fundamental to our medium-term prospects in Australia.

Dr LEIGH—On the independent assistance provided to RBA board members, are you comfortable about the level of independent advice provided to members of the board?

Mr Stevens—It is a matter of whether they are comfortable really. We provide a tremendous volume of detailed material every month and these two guys occupy the bulk of the meeting with presentations. My sense is that the members are highly engaged in that process. I think they regard very highly the quality of the material that we give them. They have a lot of sources of advice, information and insight because people in the business world are, as you know, very plugged into a whole group of other entities, including offshore businesses. The head of the Treasury has the not insubstantial resources of his own department, and the academic member is across a whole manner of other issues as well. So I think they have pretty good access to information. If they want more from us, they ask for it.

I am comfortable with that, but then I am the chairman and I of course have access to a huge amount more material than we can possibly give to the board. So the real question is whether they are comfortable with it. They have not said to me that they are not, but you would really have to ask them for a full answer to the question. But I am not aware of them expressing reservations.

Mr BUCHHOLZ—Can I go back to having a chat about the two-speed economy and pick up your point on the multi-speed economy. In my electorate we have a retail sector that is doing it extremely tough. It is a strong mortgage belt with mums and dads doing it tough and the Aussie dollar is having an impact on our exports, so right throughout our sector we are doing it tough. Are there any other vehicles or tools available to use other than interest rate movements for steadying the economy?

Mr Stevens—We have got the overnight price of money. Basically that is the tool that a central bank has. Many years ago there used to be a thought that we could also direct banks on how to lend, who to and how much and so on. Most of the time the attempt was to restrain, because interest rates were too low fundamentally and the credit wanted to grow and we kept trying to tell the banks, ‘Please slow down,’ which they responded to in large part by just creating a non-bank subsidiary to do the lending—a large part. So we came to feel—and I am going back 30 or 40 years here—that by and large those direct controls were pretty ineffective.

The fundamental issue that you are really getting at is: Australia has got one monetary policy because we are one country with a shared currency and a single central bank. What we can do is set the policy for the average conditions knowing full well that there may not actually be
anybody experiencing the average conditions. Some are below and some are above. So the rate we set is by the sound of it too high for your area and not high enough if you live in Karratha. There is not really a solution to that problem per se unless we have multiple currency areas and multiple monetary policies for the country, which has its own problems. It probably does not sound very sympathetic to say this.

The conditions that economists usually look for in answering the question are: is a region an appropriate area to have one monetary policy, or do the productive resources flow within the region fairly easily to respond to too much demand here and not enough there? Are there other policy mechanisms, like fiscal mechanisms, which redistribute income to help even out these differences? Mostly, when you look at that for Australia, I think you would probably come to the conclusion that, yes, there are. There are fiscal transfer mechanisms that do not totally even out these things but go some way to evening out the differences in demand across the country. If you were to compare us to even America or Europe—I do not mean to sound as though we do not care about these differences or that they are unimportant; far from it—the various devices that we have in Australia to help ameliorate the differences by and large do a reasonable job, I think, at least in comparison with countries with which we might draw the comparison.

So I do not have another tool and it is really up to other arms of policies to help manage these regional differences. I think we best manage them not by trying to resist the forces for change but rather by helping the change happen more smoothly and helping the people who bear the cost through it.

Mr BUCHHOLZ—You have an inflation range of two to three per cent. We received some data showing there is an unprecedented level of investment in mining, 20 per cent increases, and I think there was a comment earlier about once-in-a-century-type capital investment which will have inflationary pressures. In the two to three per cent inflation range, will there be much elasticity? Can we move that range out to accommodate this once-in-a-century situation? If we do go outside those parameters, for how long can we do it?

Mr Stevens—The promise that we make actually is not that we will always be between two and three per cent. In fact, half the time we are not; we have been above and we have been below. In practice, you really cannot fine-tune—or at least we have not been able to fine-tune—inflation so closely that you are never outside that band. So it is not a band in that sense; it is a central tendency. Two years ago we were at five per cent which was way too high and we wanted to come down. We set policy to that objective and it has come down. Over the 17 years since we first articulated the target, the average CPI inflation rate in that period is pretty much exactly 2.5 per cent. So we have been as low as one per cent and as high as five per cent. We have been outside the two to three per cent probably almost half the time, but the average—which is what matters most—is bang on 2½. That is what we are seeking to deliver.

So if something happens unexpectedly which pushes us outside, our job is to try to come back over time but not so quickly as to crush the real economy in the process. Likewise when we are below, which we were at one point for some time back in the late 90s, we set policy to allow inflation to come back, but we did not seek to stoke up an unsustainable boom to get it to zoom up within a very short period. So I think the system has a degree of elasticity, but it relies on us always aiming at least to be, at the end of our horizon which is three years out, at two-point-something. We know there will be shocks one way or other, surprises, things we cannot foresee.
or even mistakes we make, that will lead us away from 2½ some of the time, but the commitment we make is to so set policy that, at least in expectation at the end of the horizon, if it is not at 2.5 per cent it is heading towards it or pretty close to it.

I am not under any illusions that it is a perfectly straightforward matter to keep to an inflation target in the face of these very big shocks, but it is the central bank’s job to try to do so. I think we can expect reasonable success, and if we are temporarily above or below it is not a disaster as long as the average performance comes back, which it always has to date and that is our commitment in the future. What would be a mistake, I think, is to say, ‘Let’s set a higher target because it is just too hard to meet the low one.’ That would get us nowhere. What that would do is get us higher interest rates in the long run.

Mr BUCHHOLZ—I am not suggesting that for a moment.

Mr Stevens—No, you are not; I see that.

Mr BUCHHOLZ—Any interest rate movement hurts my guys. You mentioned earlier that for quite some time interest rates should be uninterrupted. How long is quite some time?

Mr Stevens—I cannot tell you—

Mr BUCHHOLZ—Twelve months?

Mr Stevens—because I do not know.

Mr BUCHHOLZ—I tried that one earlier!

Mr Stevens—If I do know, it is not appropriate for me to say. The fact is that I cannot tell you with certainty exactly what we are going to be doing six months from now—it just does not work that way. If we were a long way away from what you consider normal, it would be very unusual to persist with that over a long period. So we were quite comfortable, when we were a long way from normal, in saying: ‘This isn’t going to last all that long. We’re going to have to go back to normal.’ We are now a bit above normal but not by so much that I could say that I am very confident that that will not last. Frankly, if you are at a point where you are quite sure that in a certain number of months time I am going to have to do something, the real question is: why aren’t you doing it now if you are that sure?

Mr BUCHHOLZ—Did Rick make some comments saying he thought that they were going to move in the next 12 months?

Mr Stevens—I cannot recall whether he said that or not, but 12 months is a fair time and—as Guy said earlier—there will probably be some more next year and maybe a little bit more after that. It is not unreasonable to think that if you buy the central scenario that we have sketched out. One way or another something will happen to take us off course, but that is the central view. It is not unreasonable for people to think that, but that is just saying that it is unlikely there will be anything from us imminently, and I think that is probably a reasonable expectation of people just now.
Mr BUCHHOLZ—His comments were:

If economic conditions evolve as the Board currently expects, it is likely that higher interest rates will be required, at some point, to ensure that inflation remains consistent with the medium-term target.’

Mr Stevens—If you look at the forecasts we published, which have inflation at about where it is now for another year but tending to edge higher in the two out-years—and that forecast is explicitly predicated on the market pricing at the time the forecast was done, which had some increase—that all fits together. But I do not think it is sensible to speculate about increases right now.

Mr BUCHHOLZ—That is fine—I was not trying to trap you or anything. There were some other questions, but the majority of them have been covered off. My last question is about lending to developers. I think you have an interest in it. It has a direct impact on housing prices at the retail level. Do you want to make some comment about why the banks have tightened up and about the benefits of potentially loosening that part of the sector up?

Mr Stevens—The standards are tighter than they were. The big historical backdrop here, as I was saying about Ireland, is that when banking systems get into trouble it is almost always with property. Why is that? Because you have asset price movements and there is a leverage, so the borrower is suddenly in trouble because he is over-geared—it might be a homeowner, as it was in America, and it is often developers—and then not long after that the lender has some problems because his asset quality is deteriorating.

From that very broad historical perspective it is quite appropriate for banks to be very careful about lending for commercial property. Are they being too tough right now? Maybe they are. It is, and I think we might have covered this in earlier hearings, human nature for the guy a who is approving the loan—and this is not the CEO of the bank or the board; it is a guy who feels that he might lose his job if he makes a loan that goes bad—to be cautious. In the circumstances we have had in the past two or three years, that person would be only human if they were being much more careful—and possibly slightly too careful. So I think that is possible. But banks have limits on the proportion of the portfolio that they want to have in commercial property. That means that if the overall portfolio is not growing—and it is not growing very much right now—then the property bit cannot either, because then it gets above its desired weight. So that could be an issue just at the moment.

More generally, it could be that we need development finance to have more equity relative to debt than it has historically tended to have, in order to be safer. And of course the banks are not providers of equity finance. So another question might be about the availability of equity. It probably is happening at the smaller levels. Certainly, people I have talked to have said there is some equity money around that is starting to go into property development. But we are not talking the really huge tower type things there; we are talking smaller things. So there are some structural questions which arise here. I am not sure we would solve them by having the banks relax their standards too much. That said, I think what we probably will see in the coming couple of years is the banks trying to do more. It is probably not going to happen fast enough to satisfy people like you and many others we talk to who feel that it is just a bit too tough. I know that.
Mr BUCHHOLZ—Have a chat to them and see how you go.

Mr Stevens—It is an unusual thing for a central bank governor to try to press banks to lend more. Our typical role is the other way.

Mr BUCHHOLZ—Thanks for your time.

Mr STEPHEN JONES—Batting at the tail end, you can miss all the really good shots, and you can pick up a few things.

Mr Stevens—You can bat that last stand that wins the game.

Mr BUCHHOLZ—That is right.

Mr STEPHEN JONES—There are a couple of themes that have emerged. Firstly, I am interested in your observation on utility prices—on what was driving the rapid increase in prices over the last 12 months and why you say that the rate of inflation in price increases for utilities has flattened out.

Mr Stevens—It seems to have. Dr Lowe could fill in more details perhaps if you would like that—I can give some general background. If you take electricity, looking back, there was a long period where we were probably flattered by how low the prices were for a long time; the true rate of inflation might have been just a fraction higher—not a lot, maybe 0.1 or 0.2—back in the mid-nineties until now. But at some point more capacity has to be put in. Much of the price rises are in the network distribution part, which I think is subject to regulatory pricing, and the regulators have acceded to a case to allow prices to go up to recover networking costs. I think probably we are going to see, over the years ahead, that there needs to be more generating capacity, and that has to be paid for too. Either the taxpayer subsidises that, or the users pay the price. One could debate which is better. But the general story here—and this would probably also be the case for water—is that we had a lengthy period where we were probably underinvesting in capacity, and sooner or later you have to make that up. Analytically, it is best thought of as a one-time rise in prices, but it filters out over several years so we observe it as a higher rate of inflation in these parts of the CPI for a time.

Now I think we feel that the peak rate of year ended increase has passed—would that be right? But the rate of increase nonetheless will remain well above the average rate of increase in the CPI for a while as these prices rises filter through. So it is really a capacity thing, and we perhaps as a country were not putting in enough capacity in the past and we are now trying to catch up, and we have to do that.

Mr STEPHEN JONES—My second question goes to observations in the statement on monetary policy about the increase in household savings over consumption. Firstly, do you think this is a sustained trend? If so, what are the economic consequences over the medium term of this?

Mr Stevens—There has been quite a noticeable rise in the saving rate. Looking back, the low point was probably about five years ago. As with many of these trends, they have to be in place for a while before you can be confident they are really there. We are assuming that at least some
of this greater propensity to save will continue. If it does not then consumption would be stronger than we have assumed. I think that is a reasonable assumption, based on the sense that I have, at least, that we have all looked at the previous period, looked at households in other countries getting into serious trouble and thought, ‘We ought to be a bit careful about rate of borrowing and maybe we should be saving more of our current income as opposed to allowing an assumed rise in asset values to, in effect, do our saving for us.’ I think that is a tendency that was there a few years back in many countries. My guess is that there has been a kind of sea change in people’s attitudes that we would expect to persist for a while.

Retailers do find this tough. We hear this all the time from them. It is tough. People have money but you have to work harder to get them to part with it now than you did a couple of years ago. That is putting competitive pressure on pricing, which is one of the things that is helping us keep inflation low. A higher exchange rate is helping them do that because the imported products are getting cheaper. We have a bit more of that ahead, I think.

At a very broad level, household activity on consumption, borrowing for housing and so on was one of the leading drivers for how growth happened for some years. I do not think it is now. We are now in a world where the business investment drivers as a result of the terms of trade stories are the leading part and the households are following rather than leading. But from an overall economic point of view we probably need that. If they were trying to still lead then we would be having overheating. My guess is that that will continue for the period ahead. We are making that assumption.

Mr STEPHEN JONES—You mentioned the link between the higher exchange rate and the suppression on inflation. I would like to explore that a bit because we hear a lot about the impact of inflation on exporters. I am the member for Throsby. I come from Throsby, and the Illawarra has the largest steel manufacturing plant in Australia. There is a big impact in that sector, but I would like to hear a bit more from you about what you see as being the benefits of the stronger Australian dollar, particularly in relation to inflation.

Mr Stevens—It lowers the prices for tradeable goods. If you are a producer of those trying to export them, such as steel or any number of manufactured goods or for that matter services, if you are a price taker in global markets then the local currency price has to go down as the exchange rate goes up. If you are an importer then your purchasing power has gone up and you can enjoy higher margins or you can pass on price gains to your customers—or some of each. That is what we are seeing. In a way, from an economy wide perspective, what has occurred is that we have had a big lift in the terms of trade. And it is big. It is 50 per cent or 60 per cent higher than the 100-year average. The exchange rate has reflected that very fully. What that does is transfer some of the income gain, because the terms of trade rise is an income gain. So our purchasing power over imports goes up and it transfers part of the gain and income from the miners, who directly get it, to consumers, who get purchasing power over imports. So the transfer of income happens via the exchange rate.

That does help to hold down inflation. It spills some of our demand into offshore rather than meeting it all locally, so that is less inflationary and so on, but it makes it harder for exporters who are not miners. The miners can cope with it because the price of iron ore has gone from $25 to $125 a tonne. The exchange rate still leaves them very profitable. But people exporting education services are really feeling it because their foreign currency price has not gone up.
They have to lower the Australian dollar price they charge in order to compete. As Ken Henry I think said the other day, it is almost a three-speed economy—there is the mining sector, the traded part of the economy that is not mining and is affected by the exchange rate, and the rest.

Mr CIOBO—I want to ask about the RBA’s oversight of Securency. As I understand it, from the year 2000 onwards around $50 million in commissions was paid to agents abroad, around $23 million of which was paid to three different groups of agents to secure contracts in Nigeria. Reports came out about concern that the Securency structure by which the RBA appoints the chairman and three directors, as I understand it, had facilitated payments by Securency to a number of known tax havens such as the Seychelles. I am interested to know, from a governance point of view, why after May 2009 further payments of $5.8 million were allowed to be wired to the Seychelles and a further $1.45 million was wired by Securency to the Seychelles. What controls are you aware of that the RBA-appointed chairman and directors exercised in terms of an audit role on the actual use of this money? Although you are selling Securency now, what steps will the RBA be taking to ensure that directors and the chairman complied with their responsibilities separate from the police inquiry that is currently under way.

Mr Stevens—that is a big set of questions. As you know, the police inquiry is ongoing. The allegations made in the Age were in May. They were allegations. The company began an internal investigation into practices surrounding payments to agents, which was carried out by KPMG, and it was also referred immediately to the Federal Police, who then commenced their own investigation. The Seychelles, as far as I know, is on a list of OECD countries where it is permissible to make payments, so I think the stuff about it being a tax haven and somehow improper is not right. The payments were made in accordance with the terms in the contract, because the company was obligated to make them under the terms of that contract unless there was a reason to say no, the contract should be stopped. At that point, early in the investigation, I do not think the company felt they had any grounds to make that decision. We still do not know what the ultimate outcome of the police inquiry is going to be. In due course we will find out. At this point, many allegations have been made and the substance or otherwise of them is what the police are looking into.

As far as the chairman and the directors go, I would be very confident that the chairman and the directors that are there now have acted entirely properly throughout, and I have not seen any evidence that the directors that we appointed or the chairman that we appointed have acted improperly at any time. And I do not think that is being claimed, actually.

Mr CIOBO—Has the RBA exercised itself to determine whether or not they have complied or are you just saying your gut instinct is that they have complied?

Mr Stevens—No, it is more than a gut instinct. There has been quite detailed work done to just assess that proper process was followed at all times. It has been quite extensive. There has been no evidence of any improper behaviour by any of the directors or the chairman that we have appointed—not that I have seen, and I very much doubt there will be. But, of course, the police are continuing their investigations at this point.

CHAIR—Thank you for that.

Resolved (on motion by Ms Owens):
That this committee authorises publication, including publication on the parliamentary database today, of the transcript of the evidence given before it at the public hearing today.

Committee adjourned at 12.36 pm