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STANDING COMMITTEE ON ECONOMICS

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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 and Ms Owens and Mr Craig Thomson

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2010
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LOWE, Dr Philip William, Assistant Governor, Economic Group, Reserve Bank of Australia

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

CHAIR (Mr Craig Thomson)—I declare open this hearing of the House of Representatives Standing Committee on Economics and welcome representatives of the Reserve Bank and members of the public and the media. I thank the governor for that short indulgence while we had a very quick meeting. Today the committee will scrutinise the RBA over its projections for the Australian economy. With the recent devastating floods in Queensland and Victoria and Cyclone Yasi, the committee will be interested to hear the bank’s opinion on what effects these disasters may have on the Australian economy—in particular, considering that inflation is currently within the RBA’s target band, whether there will be a need for further rises or, with the disasters, whether now is the time for caution. Since October 2009 the RBA has lifted the cash rate seven times, taking it from three per cent to 4.75 per cent. Current economic conditions and forecasts suggest that the Reserve Bank may well be considering further increases in the cash rate. Unemployment is at five per cent and the bank is forecasting underlying inflation to increase to three per cent by late 2012. Increases in the cash rate could affect our exchange rate. If our trading partners keep their interest rates low then we would conceivably see the Australian dollar go well past parity with the US dollar. This would further affect our exporters and importers.

In the minutes of its board meeting last December, the bank noted that much of the growth in our real incomes has come from the favourable change in our terms of trade but that productivity growth in Australia has slowed significantly since the 1990s. This theme also occurred in a recent report from the Grattan Institute which suggested that Australian productivity decreased over the past five years. The committee is interested in any advice the bank can provide on this topical matter.

Once again, on behalf of the committee, I welcome the governor and other senior officials of the Reserve Bank of Australia to this hearing. I remind you that the committee does not require you to give evidence under oath. The hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as contempt of parliament. Welcome to today’s hearing. Mr Stevens, would you make your opening statement before we proceed to questions?

Mr Stevens—Thank you, Mr Chairman. It is good to be back before your committee. You seem to have shifted to the right. I am not sure what significance I should attach to that. Anyhow, it is a short period since we last met. In that time, I would say, the global economy has continued to expand and if anything probably looks a little stronger than it did when we were last here. China and India have sustained a strong pace of expansion and the United States seems to be gathering a bit more momentum, though it still faces considerable problems. Conditions in
Europe remain quite mixed and the ongoing interplay of sovereign and bank creditworthiness issues there continues to be a source of great uncertainty.

Observers have been revising up both the estimates of global growth outcomes for 2010 and, at the margin, their forecast of growth in 2011. The IMF is now saying world GDP growth was probably about five per cent in 2010, which is well above the 30-year average. For 2011, the fund has lifted its forecast to 4.4 per cent, which is still noticeably above the average pace of growth. Global commodity prices have risen further in recent months. This has been quite widespread—metals, minerals, energy and foodstuffs. In a number of countries, measures of consumer price inflation have reflected this rise in commodity prices, particularly in the case of food. For China, India and in fact much of Asia and Latin America, these are all important issues and managing these pressures I think is shaping up as one of the major international economic policy challenges for 2011.

The commodity prices most important for Australia are at very high levels. In the case of coal just now, this partly reflects the supply tightness resulting from the floods in Queensland, which we think have reduced national production by something like 15 per cent, and that has a material impact on the global supply of traded coal. But the supply of iron ore has not been much affected by the weather, and its price has risen above the highs of 2008, driven by strong demand. As a result, Australia’s terms of trade are higher than we assumed three months ago and look like they will peak higher and later than previously expected. A large build-up of capacity in iron ore, natural gas and coal is planned, and over the summer there have been further announcements of projects that had been proposed being given the go-ahead, principally in the gas sector.

In broad terms, therefore, the main medium-term story the bank has been pointing to for some time still seems to be in place. We are experiencing a terms of trade event of a very large size, of the type that happens only once or twice in a century. Our job, of course, as policy makers is to try to manage that as best we can to avoid as far as possible the instability that has accompanied most such episodes in the past. To date, something that is probably unusual in the face of these developments is the relatively cautious attitude of households towards their finances. This has been much remarked on recently but in fact, looking back, it seems that the rate of saving out of current income has been rising for several years now. A caveat, of course, is that the measurement of saving, being the residual between two very large aggregates, cannot be as accurate as some other measurements that are done. But, given that caveat, it looks like the propensity to save out of new income has been fairly high recently and that people are working to reduce their debt more quickly and are more demanding of value in their purchases than they were before.

This is no doubt a difficult environment for retailers. From a macroeconomic point of view, perhaps on balance it is not entirely unwelcome in the current circumstances. The reason I say that is that, if consumption were to boom at the same time as we try to expand the resources sector, upgrade urban infrastructure and increase our pace of housing construction to house a growing population, it would be harder to avoid the economy overheating. The more cautious behaviour by households is also, I think, building some resilience into household balance sheets, and that will be a good thing to have in the future should developments at some point turn in an unfavourable direction.
The ratio of household debt to income seems to have stopped rising, having been going up for about 20 years. That is happening in a number of countries. It is not just here, so the factors behind it are not just local ones. But we have in this country the good fortune to be seeing this desire to have consolidation in household finances happening at a time when our incomes are going up because of the terms of trade story. That is an advantage that many other countries do not have.

Locally, attention has of course been focused on the devastation caused by extreme weather across several states, most particularly in Queensland. I imagine we will spend some time today talking about the economic costs of this. It is important to say, I think, that the human cost cannot be quantified in dollars or per cent of GDP or those sorts of things, and the people affected are still absorbing that cost and some of them are going to be doing so a long time after the economic costs are not being talked about any more. Those of us who have not been directly affected have admired the courage and resilience of those people as they faced these devastating events.

The Reserve Bank, for its part, has an obligation to consider the impact on the national economy. To do that there are a number of questions we have to ask and seek to answer. I will outline three of them. How large are the effects on output and prices that we should expect to see? Are they due to demand disturbances or supply ones, because that matters? How long will they last—that is, do they change the medium-term outlook for the economy significantly?

It is early days. We had a stab at setting out some estimates in the Statement on monetary policy released the other day. That was finalised after we had seen the flooding in Central Queensland in December and more coastal flooding in January but before Cyclone Yasi had made landfall, so we could not assess that. I should emphasise that all these estimates are preliminary and there is inevitably going to be a great deal of uncertainty around them. I think that will remain the case for some months.

With those caveats, the estimates we put together suggest that real GDP will be noticeably lower than it would have been in the absence of these events in the December and, particularly, the March quarters. By the March quarter, we think it could be about a percentage point lower than the forecast we had when we were last here. As to the reasons for those effects, it is not primarily because demand for goods and services has suddenly slumped. It is mainly because the economy’s capacity to supply goods and services, particularly certain commodities, has been seriously disrupted. It is likely that the bulk of those supply losses will be recovered in the June quarter as production, particularly in coal mining, which is a very big swing factor here, resumes. Nevertheless, for many businesses there has been a period of lost income and the reduction in the level of GDP on average for the year of about half a per cent—this is the number that the government quoted and we have roughly the same figure—is one metric of the fact that there has been a period of lost income for those firms that will not really come back.

After the initial period of recovery and production over the months ahead, there is going to be a process of rebuilding damaged structures, houses and so on. That will be accommodated in part by the deferral of some other spending but we will see some modest increment to overall demand over the coming year or two compared with what we expected some months ago.
Since we put those estimates together, Cyclone Yasi has done major damage to some crops, particularly bananas, as we know. We have some very early intelligence that suggests that the extent of damage may not be quite as great as occurred with Cyclone Larry five years ago and that the recovery of some of the crops might be a little quicker than during that episode. Nonetheless, there has been a very substantial impact, and a large rise in the prices of some fruits like bananas is already occurring. That is on top of price increases that will be occurring for foodstuffs as a result of earlier flood events.

The result of that is likely to be a temporary rise in CPI inflation to probably around three per cent, we think, for the June quarter. That is a higher figure than was in the statement we released the other day because we have now factored in an effect from the cyclone that was not in that forecast. The combined contributions to that three per cent number of all the summer flood events and the cyclone is probably half a percentage point or maybe even slightly more. These effects should begin to reverse in the second half of the year and should be largely gone by the end of the year, we think.

We do not think that the impacts on economic activity that I have talked about will derail the expansion, nor should the price effects pose a serious threat to the achievement of the inflation target over the medium term, provided that the community can understand their temporary nature, and we all have a job to do there in helping people understand the temporary nature of it so that expectations of ongoing inflation can remain well anchored. I think we will be able to do that.

Accordingly, the board’s view at the recent meeting was that, while there will be substantial impacts on the short-term path of economic activity and prices, monetary policy should not respond to those—either the price impacts or the activity ones. Likewise, while the recovery efforts will probably add a little bit to aggregate demand in the latter part of this year and next year, we think those effects are manageable in an economy of this size. We did not have an assessment of the cyclone at the meeting but our assessment of the medium-term outlook today would not be very different to the one we had at the board meeting. So that is the assessment we made on the way monetary policy should look at these things. In brief, as everybody is saying, we are going to look through these various impacts and keep the focus on the medium term.

Coming to inflation, the outcomes in the latter part of last year were moderate and probably a little lower than we had thought they would be. As always, assessing to what extent that is a signal of a lower medium-term trend, as opposed to noise, is difficult. There would appear to be some association between the consumer caution that I talked about and reports of widespread discounting in the retail sector, and of course this is facilitated by the exchange rate being very high. If that connection is in operation then one uncertainty about the outlook, of course, is how long this cautious behaviour will last. That is one of the things that we flag in the risks section of the Statement on monetary policy. It is not the only uncertainty but it certainly is one of them.

Stepping back, though, to take the broader picture, underlying inflation has fallen substantially from its peak in 2008. It needed to, but it has. And I think it is worth recording that, on the latest numbers we have, we have an unemployment rate of five per cent and an inflation rate clearly in the twos, which is where we want it to be. That combination, when you go back and look at recent decades, actually is a pretty favourable one compared to many that we have had.
Turning finally and in conclusion to monetary policy itself, as a result of the adjustment to the cash rate in November and the changes that lenders made, which were a bit greater than that, interest rates being paid by borrowers are a bit above average compared to the past 15 years. Household credit growth is positive but moderate, business credit is still declining as many firms are still seeking to lower gearing and consolidate balance sheets, and in the case of larger companies they are able to access capital markets directly. Reports do suggest that there is some easing of lending conditions starting in some areas, though my sense generally is that lenders remain fairly cautious. The exchange rate is very high. It is at a peak level for the floating era, since 1983. That is not altogether surprising, given how high the terms of trade are, but it is exerting a dampening pressure on the traded sector of the economy outside the resource sector. Overall, I would say conditions are on the firm side. In view of the outlook for the medium term that we have, I think that is appropriate. Having reached that position, though, in a fairly timely fashion the board has judged it recently sensible to sit and leave the cash rate steady.

That is what I wanted to say, Mr Chairman. I look forward to your questions.

CHAIR—Thank you for that, Governor. I will kick off the questions. You have said in your statement that retail sales were relatively low, particularly in December, inflation is within the band and slightly better than when we last met for the medium-term projections. You have also made comments on the cautious approach by householders in relation to savings and you concluded by talking about interest rates being a bit above average. Does that mean that interest rates are now on hold for the foreseeable future?

Mr Stevens—How long is the foreseeable future; how long is a piece of string? Last time we met I think I said at that point of time that, with respect to the pricing in financial markets, which we take as a technical assumption for putting the forecast together, there was no anticipation of any change in the cash rate for some time. There has not been since then and they still have that expectation. As I said then, that is probably a reasonable expectation to have. It was reasonable based on what we knew then, and I think it is reasonable based on what we now know for them to hold that view. So I would not be seeking to dissuade people from that view. Whether it turns out that rates do not change for an extended period—of course, it may—no-one will be happier than me. But things happen. We cannot know for sure, but that is what people currently expect. Based on the current outlook that we have, that is probably reasonable.

CHAIR—Is there an argument for an easing of rates over the period of time, given your prognosis of inflation and given your statement about interest rates being a bit above average, compared to the past?

Mr Stevens—I think it is about right for them to be where they are, given that we have a once-in-a-century terms of trade event that is very expansionary and all the things that flow from that. It would be surprising if you did not have to have policy a bit on the tight side of normal in that event, taking account of the fact that the exchange rate is doing a fair bit of work for us. I think there would only be an argument for an easing if that strength looked like it was significantly dissipating or if we had some other very important piece of news that was quite view changing. At the moment, the medium-term inflation outlook is not really very different. Where we think it will be in two years from now is pretty similar to where we previously thought it would be. The near-term trajectory is a little lower because of working in the history of the low figure we got. The CPI basis is actually a bit higher because of the flood effects and
so on, which we are saying will pass. But the medium term at this point does not look very
different. Terms of trade actually look stronger, but we are saying that the medium-term inflation
outlook is pretty similar to last time. So I think that says that policy is about right.

CHAIR—What are your expectations in relation to our foreign exchange rate with the US
dollar and if that significantly changes or improves, as has been suggested by the market over
the next 12 months, does that have an effect in terms of—

Mr Stevens—A material change in the exchange rate can often have a significant bearing. It
depends why it occurs, though. Also, some people in the market are saying that; some are saying
it will go down. The fact is that nobody knows and it is a variable which the economics
profession is particularly poor at forecasting, which is why we tend to assume no change because
that actually is as good a forecast as any other. But the broader point is that if it rises because the
terms of trade outlook and the economic outlook is actually even stronger, that will be one
signal. If it were rising because some other factor was pushing it up and the real economic
outlook was not stronger then that would be very a different message for monetary policy. So it
depends what the thing is that drives it up. When we think about the exchange rate, we always
have to ask that question before we can come to an answer as to what that means for monetary
policy. In truth, no-one really knows what it is going to do. Someone who does know can make a
lot of money, and not many people systematically do make money in that market.

CHAIR—If they did, they probably would not be sitting here, I suggest, Governor. I want to
turn to the November increase and review it with hindsight, which clearly the board did not have
the opportunity of doing. Given what has happened in Queensland and given the longer term
forecasts that you have made, is there an argument that the rates did not need to move in
November, particularly given the events in Queensland, and that there would be no significant
difference in relation to the economy?

Mr Stevens—One rate rise or 1½ even, as that one was—they usually do not make a major
difference anyway. It is whether you have got the level roughly right that really matters for the
medium-term path of the economy. I think the level is roughly right. I think it was the right call.
I think if we had not done it in November we would have been sitting there in December with
the same outlook, feeling, ‘We really are going to have to soon.’ If we had not done it then we
would be coming into February and then the picture would have been much more complicated,
as you say. But I feel that the current level is about right for the medium-term outlook that we
have. As I say, we are going to have a lot of disruption from the flooding, both on output and
prices, and some impacts of the rebuilding. But through all that, in two years time—unless we
have got this wrong—the economy is going to be looking pretty similar to what we thought it
was going to look like when we made that decision. So I think it was the right call, even in
hindsight.

CHAIR—Many of us were critical of the banks supersizing that last increase and many
households have obviously been hurting because of that supersize. I notice that the CEO of the
Commonwealth Bank made some recent comments suggesting that, in all likelihood, that would
not be a path they would go down in the future. Do you want to give some commentary in
relation to that particular statement that was made and how that may affect your decisions in the
future?
Mr Stevens—Do you mean his statement yesterday?

CHAIR—Yes.

Mr Stevens—We need to be careful we do not get into price signalling here, I suppose. Generally speaking, the relationship between changes in the cash rate and changes in the whole structure of deposit and loan rates is a function of what happens in the marketplace. Since November I do not think market funding costs have really done anything very much relative to the cash rate. It is very gradual. As they roll over the five-year debt up here compared to down there, that is coming and it is a basis point a month worth, maybe. I think the CBA said that. So that is still happening and it will keep happening until we get to about five years after the widening in spreads first occurred, which was back in 2007 or 2008. Apart from that though I do not think there has been any material change in the structure of the other things that drive funding costs, since November, have there, Ric?

Mr Battellino—No. As Glenn said, the cost of long-term debt continues to rise. It is probably adding about five basis points a year to banks’ cost of funds. The Commonwealth Bank was the bank with the lowest margins through last year and, because of the mix of its funding and its lending, it had quite low margins. Those measures it took sort of restored the margins. My guess is that Mr Norris’s comments yesterday suggested that he is feeling more comfortable now with the current level of margins.

CHAIR—I am partly asking the question because in the past you have made the point that, when the reserve makes its decision, it takes into account what is happening independently with the banks. Given that statement yesterday, is the expectation that banks will not be moving beyond rises in the cash rate?

Mr Stevens—we are not contemplating a rise now but, if we were, I think it is not very likely that there would be material changes right at the moment. It is an analytical point, but since we are not contemplating a rise right now we do not have to worry too much.

CHAIR—Turning now to Queensland, you did provide us with your views in relation to that in your opening statement, but I want to go a little bit to your views on the effect of the capacity constraints with the rebuilding after the Queensland floods in the medium term. On a number of occasions you have made comments about the difficulties with capacity constraints here and the pressures they create. What additional pressures do you think have come from these natural disasters?

Mr Stevens—we have made the point for some years that capacity is an issue for the economy generally and I think we have seen evidence of that in a whole range of areas. I suppose there are two general points I would make about rebuilding and I will ask Philip to add any detail he wants to. My two general points are that the rebuilding is to some extent being accommodated by slowing down other areas of spending, so that helps with the capacity issue. In terms of constructing dwellings and things like that, if there were one region where you would think there is more capacity available than elsewhere, it is probably South-East Queensland, because in the lead-up to this episode it had among the weaker performances of house building and so on, for various reasons. That at least at the margin says that the capacity to construct some thousands of dwellings extra over the next couple of years, starting from where they
started, is probably better there than it would be if it were happening in Melbourne, say, where things are much stronger. We probably should not overstate the capacity issues in this particular episode. Phil, is there anything that should be added there?

**Dr Lowe**—In the analysis that we put in the *Statement of monetary policy* last week, we said we thought that over the next two years there could be up to $8 billion of additional spending in repairing and rebuilding the infrastructure. You have to put that in the context of a $1.4 trillion economy. So $8 billion is a significant number but it is not, in the context of a $1.4 trillion economy, unmanageable. Think of the recent coal seam methane projects announced in Queensland. There are two of those projects. They are $15 billion each of additional spending over a three or four year period. So it is large but it is manageable.

In the construction of dwellings, I think there is probably a couple of billion dollars there. A few thousand houses will have to be completely replaced and 20,000 or 30,000 will have to have significant rebuilding or repairs done to them. But, as the governor was saying, there is some spare capacity in the Queensland construction sector at the moment. So it is significant but I think it is manageable.

**CHAIR**—In relation to the natural disasters in Queensland, you spoke about a short-term spike in prices, but the role that we all play in managing those expectations of inflation. Would you like to go into a little bit more detail about what you meant by that and how short-term you see that spike being?

**Mr Stevens**—The peak for CPI inflation is going to be three per cent in the first half of the year. It is then going to go down a bit. The forecast is that underlying actually starts to edge up by the end of the year, so you have got two things working there. But the point about inflation expectations is important, because generally when we have a sharp spike, either up or down, in inflation and we are saying, ‘It wouldn’t be sensible to tighten monetary policy because inflation is temporarily rising because of a supply shock,’ we look through it, we look to the other side and we say, ‘It’s going to come down, so we shouldn’t raise rates in response to that.’ That is the right analysis.

The assumption we are making in being able to have that analysis is that people’s expectations of the permanent inflation rate do not go up. I do not think they will actually. We have seen these sorts of things before. People understand that. People correctly sense that prices of fruit and vegetables and so on are going to go higher for a while. The damaging thing would be if they took that to mean that inflation everywhere is going to stay high permanently. Then we have got a problem, because it is not so easy then to say that monetary policy should not respond to that. It would have to if that turned out to be the problem.

So that is why it is important for us to help people understand the temporary nature of things, and that is why we have set this out in some detail in the document. We can appeal, of course, to the Cyclone Larry experience, where banana prices went through the roof but a year or so later they were back to normal. That is what we need people to understand. So our job—those of us who comment on inflation—is to help people understand this point. I think we have got a pretty good chance of doing that, because, in the past episode, people expected inflation to be higher for a while but they did not expect it to stay higher permanently. That worked out well. I would be pretty confident we can achieve that again. We just have the job to do to explain.
CHAIR—Thank you.

Mr CIOBO—Governor and members, welcome back. I would like to explore this issue of inflation a little further, to get a better understanding about the way in which the various stimulus measures are impacting upon the economy, following on from the chairman’s line of questioning. I understand that private sector capex is forecast to be around $780 billion flowing through, the largest capital expenditure that we have seen in our economy for some time. Dr Lowe, I think you made the comment about there being approximately $8 billion of additional spending as a consequence of some of the challenges that we have faced over the summer. In addition to that we have seen some very significant state government stimulus measures and spending. I would be interested in your comments about the impact of state, public and private sector spending on inflation.

Mr Stevens—The $780 billion that you quote for private capex would be over a number of years.

Mr CIOBO—Sure.

Mr Stevens—It is a big figure. There is no doubt that private capex, as far as we can see, is going to be very high as a response to the resource prices and so on. What we do with the forecast for inflation is we take all the sources of demand and supply and put them in there and come up with an estimate for how inflation is going to track, as best we can. So the various spending and the various reductions in spending that have been announced recently in order to accommodate the gross impact of the recovery from floods and so on—so far as the public sector is concerned anyway—are all factored in as well. The outcome we come up with is an inflation rate that is in the twos for the near term and probably drifts up a bit the further out we go. With that forecast, of course, there is a while yet to see whether it comes true, but that is the outcome we have. That is the combination of the build-up of all the demands that we anticipate in the economy relative to what we think its potential capacity to supply is.

Mr CIOBO—Could you put some context around the size of that private sector capex from a historical point of view?

Mr Stevens—The way we would think about it is as a share of GDP. Is there a chart on that in the SMP?

Dr Lowe—I think so, it is particularly around mining investment.

Mr Stevens—Mining investment is going up several percentage points of GDP. It has already done so and probably will go up another one or two. That is very high. It is one of the highest that you would find if you went back through the history. Certainly the average since the early 1960s is that mining investment may be running at a bit under two per cent or around two and it is going to be on its way to 5½ so that is a big change. Some other parts of investment will be a little lower because we are having structural change in the economy, but it is a big story. There is no question about that. That is the story we have been telling.

Mr CIOBO—So it would be perhaps not inappropriate to say it is almost unprecedented in terms of this level of capex?
Mr Stevens—Mining sector investment certainly in the modern economic era of Australia—the second half of the 20th century—yes.

Mr CIOBO—More than double the average?

Mr Stevens—Yes, Ric did a long speech on this some months back. It is a very big event if it all gets done.

Mr CIOBO—I am just mindful that we also see state government levels of net debt; New South Wales, $10 billion; Queensland, $9 billion; Western Australia, $11 billion—these are also at levels that suggest a highly expansionary nature in terms of state government stimulus. Would it be fair to characterise it as such?

Mr Stevens—Are you referring to stocks outstanding of net debt or the issuance of net debt over a particular period? As a stock outstanding that would be very small. You must be referring to issuance. We have never really said that the size of public debt on issue per se in this country has been in itself a problem any time for quite a long time now. The issue really is not whether governments can fund borrowing if they need to, they can. The question really is the availability of the real productive resources to do the work. That is the question, not whether you can raise the debt funding. As we have said, we think that given the various deferrals or reductions in other spending and so on the extent of extra demand associated with the recovery is manageable in an economy of 1450 billion annual GDP.

Mr CIOBO—I am interested to explore this issue of manageability. We know for example that Access Economics in their business outlook from December last year said:

The rough rule coming out of economic models is the government would have to cut about $13 billion a year out of the budget in the next year to keep interest rates steady.

I think I actually raised a similar modelling with you at our previous hearing. The manageability aspect is at the core of this insofar as, with this largely unprecedented level of private sector expenditure, with an expansionary outlook by federal and state governments, the way you manage it is by putting up interest rates, isn’t it? That is how we keep the economy in check: through the Reserve Bank increasing the cash rate.

Mr Stevens—The announced plans for federal fiscal policy are that the stimuluses that were put in place as a result of the decisions back in late 2008 and early 2009 have come through and are now tailing off, so, strictly speaking, I think the fiscal impacts as conventionally measured would be going negative in the current fiscal year or, if not, very soon. In the states I think there is a similar story of a large build-up in spending that then tails off. So I am not sure that, strictly speaking, a characterisation of that as strongly expansionary on the growth rate of the economy would be quite right. I do not think that is so. It has been, but these programs, particularly the federal ones, were designed to then start tailing off. That has to be delivered, of course. It is always quite a challenge for governments to deliver the restraint that they promise, but that is what is supposed to be in prospect. So I am not sure it is quite right to say that it is strongly expansionary out into the future. It has been expansionary on growth, but those things are going back the other way in the future if things are delivered as promised.
Mr CIOBO—The seven interest rate increases that we have seen, which in real terms, coupled with an increase in bank margin, if not tied back to the expansionary nature of all of these—

Mr Stevens—What they are tied to is that we had a very expansionary setting of monetary policy, the lowest cash rate in 50 years, to meet what was at that time perceived—and I think rightly—as a huge threat given the global situation, and then the worst did not come to pass. We had a modest downturn. We were into recovery quite quickly. And we said, ‘Well, monetary policy should go back to normal once the economy is clearly on its way back to normal,’ which it was, so we normalised. And now, of course, we are a little bit on the tight side of normal, looking forward to the forces that we think are already building up. Demand turned out to be, in the private sector, stronger than we had feared it would. We feared it would be weaker.

Mr CIOBO—Which is a good story.

Mr Stevens—It is an incredibly good story, actually.

Mr CIOBO—Isn’t it fair to say, though, about the fiscal policy settings—and the way in which monetary policy settings were adjusted to take that into account—that the size of the fiscal policy stimulus coupled with the private sector stimulus did not take that into account in the same way that monetary policy did?

Mr Stevens—Fiscal stimulus did what it did. We observed that and we factored that into our forecasts and did what we did, and as it turns out the private sector recovered confidence pretty quickly and demand recovered faster than we had feared it would, so we responded to that. That is our job. Your question really is: would rates have been lower if the fiscal policy had been tighter?

Mr CIOBO—Precisely.

Mr Stevens—We have been through this many times—most times in these hearings—and the answer is: that is right. The second question is: is that a better outcome? Not necessarily. It could be; maybe not.

Mr CIOBO—I think you gave me that answer last time too.

Mr Stevens—Well, the presumption that interest rates always being lower is always better—I do not think that is so myself. I think that is often presumed and I do not think it should be presumed, but that is a separate debate.

Mr CIOBO—with respect to some of the pressures that we see building in the economy, I am interested in how Australia sits with respect to household debt and interest payments against disposable income. I understand that we currently sit at about 160 per cent of disposable income against household debt outstanding. I understand that, for example, Canada is 136 per cent; the United States, 128 per cent; and Germany, 98 per cent. I would be interested in your thoughts around those numbers.
Mr Stevens—The debt to income ratio here 20 years ago was low by the standards of developed countries; now it is certainly up there with the high ones. Most countries are seeing households saying, ‘Gee, maybe we’ll get this debt down a bit. We can’t keep gearing up like this.’ I think we have joined that group. It is a fair bit less disruptive to try to tame the debt build-up here than elsewhere. But, for the orders of magnitude you quoted, we are up there with the Americans, Canadians and British—or higher than some. I think that is right. To go back to my earlier comment, this is why we should not always assume that really low rates are good, because that is one of the things that can prompt people to build up much more debt than maybe they really should. That is how, some people would argue, American households got into trouble—a long period of cheap money.

Mr CIOBO—Our servicing costs are quite high by global standards, aren’t they?

Mr Stevens—Our interest rates are relatively normal, whereas in a number of other countries their cash rates are certainly extremely low. Their actual borrowing rates are not as low because the long rates drive the borrowing rates. We have rates of servicing costs that have gone up materially in a trend sense over time, reflecting the amount of debt people have taken on.

Mr CIOBO—I am also interested in your comments on the spread between the RBA cash rate and the variable mortgage rate. The 10-year average, I understand, was around 180; now I understand it is about 300. Do you have comments on that?

Mr Stevens—We are talking about a rise of a hundred points or a little more, give or take, depending on which exact product you are talking about over the three years since about the middle of 2007. That reflects the fact that the market funding costs across a range of sources have moved up materially compared to the overnight cash rate, which is why the overnight cash rate is considerably lower today than it would normally have been in these sorts of circumstances. It is to take account of that difference. I think we have said that pretty clearly many times.

Mr CIOBO—Certainly a sentiment that is expressed to me on a regular basis is that, at a time when there appears—I am guessing at the Reserve Bank’s attitude towards banking competition—there is a much lower tempo of competition in the banking sector and we have banks posting record profits and we have seen nearly a doubling of the spread between the cash rate and the standard home loan variable rate, there might be a little bit of fat in there that could be trimmed.

Mr Stevens—If we look at banks’ overall interest margins, the long-run story is that they were 500 points in the early nineties. They are now between 2½ and 2 ½ per cent. It recovered a little bit of that very recent fall in the past year or so. The long-run big story is that those margins are actually much skinnier today than they were historically.

Mr CIOBO—That is probably a consequence of cross-subsidisation.

Mr Stevens—The fall was a consequence of more transparent pricing and a lot of cost reductions in banks, which had to be done because there was competition there. So that is a story. It is true, as you say, that the competition to lend money in the mortgage space today is not as intense as it was two or three years ago. As I have said many times before, there is a lot of
competition in the banking space. It is in the area of raising money in deposits and so on. That is
where the competition is among the institutions. When funding was cheap and easy and freely
flowing three years ago, nobody worried about how we were going to fund the lending. They
said, ‘Let’s get out there and lend,’ and there was intense competition which was tending to
squeeze the margins down. But now, because of what has happened in the global economy, the
really intense competition is from banks saying, ‘How are we going to fund it? I have got to
match that guy’s deposit rate or do better and get deposits in.’ That change in the location of
where the intensity of competition is has basically been handed to Australia’s financial system
along with every other country in the world. Ric, do you want to add anything?

Mr Battellino—I think that is right. The key point is that it is not really relevant to look at the
spread between the cash rate and the lending rate because there are all sorts of other factors
affecting banks’ cost of funds. The key point is that the net interest margins of banks have not
really changed in five or six years. They got down to about 2½ per cent in about 2005 and they
really have not changed since then. They have been down as low as 2¼ and they have been up to
2½, but they are really still in that range. Subject to measurement error, you would have to say
that is pretty steady. Despite all of the debate that is going on, the picture is that the banks are
really moving their lending rates overall in line with their cost of funds. It has not changed in
five or six years.

Mr CIOBO—I guess the difficulty I have is that in an environment of lower commercial
activity banks are making record profits and I am being told that their margins are constant or
lower than they were. It does not seem to add up to me, but we will have to agree to disagree.

Mr Battellino—In dollar terms, there is no doubt that profits have continued to rise.
Everything in the economy is continuing to rise. The return on equity of banks is actually lower
than it was a few years back. That is the key point. You cannot look at things in terms of dollars
because everything is rising in dollar terms.

Mr CIOBO—I have one further line of inquiry with respect to wage price pressures. Your
Statement on monetary policy includes this passage:

Private-sector wage growth picked up to 3.5 per cent over the year to September, following subdued growth over 2009 …
In contrast, public sector wages have grown at a consistently solid pace in recent years, and were 4.0 per cent higher over
the year to September.

I note that, with respect to wage growth by industry, we have got the public sector at the top, the
mining sector is second from the top and, interestingly, the worst performing sector of our
economy, the manufacturing sector, is now year-on-year breaking north of three per cent. Do you
have any thoughts as to the reasons why we are seeing such strong wages growth? I think you
have already explained the mining sector, but there is still the public sector and the
manufacturing sector, which is our worst performing sector.

Mr Stevens—The public sector does not tend to have a great deal of cyclical variation. In the
chart there the private numbers at the peak before they went down were at four or 4½ as well.
The private sector is more cyclically responsive. I think that has long been true. Three and a half
per se across the economy on average in the private sector is not inflation breakout territory. So
if it stays there I do not think we have got a problem with overall price pressures. We have got
five per cent unemployment as of the January figures that came out yesterday. If our forecasts are right, that will edge down over the next couple of years and we would expect to see overall private wage growth go up some more from where it has been. That is part of the gradual increase in underlying inflation we are talking about. I do not have any particular comments on manufacturing per se. Another observation I would offer is simply that, when we think back through the last several years, we had a considerable degree of variation in relative wages and that is the economy’s adjustment mechanism working as it is supposed to. One would hope that those capacities to adjust relative prices and so on remain in place as we go into this next period.

Mr STEPHEN JONES—Thank you. Mr Ciobo pursued a line of questioning which was about the tightening in monetary policy post-GFC. For a bit of context around that, how do our current interest rate settings compare with the emergency levels during the GFC and with pre-GFC interest rates?

Mr Stevens—The cash rate has risen 175 basis points since the emergency. The current level is 475 and you would have to say that historically that is actually low.

Mr STEPHEN JONES—But compared to pre-GFC it is at a low level?

Mr Stevens—Yes. The rates paid by borrowers, which went well below average—there is a chart, I think, in the document—are now back to a little bit above their average for 15 years. So they are a bit above normal, having previously been cut to well below normal very rapidly, as you know, at the turn of the year—from late 2008 to early 2009. So I would describe the current level of rates that most borrowers are paying, in absolute total terms after all the margins and so on are there, as slightly higher than the 15-year average. By ‘slightly’ I am talking 50 points maybe, give or take a bit. This is what the chart on page 49 shows. So the cash rate is below average because of the spread widening that Mr Ciobo has been talking about, and the lending rates are a little bit above average.

Mr STEPHEN JONES—The second line of inquiry deals with the cost of living. I would be interested in your thoughts on what I perceive to be a disparity between the measured rate of cost of living—inflation et cetera—and the very persistent feedback that we get from our electorates and that we read about in the media—that is, the felt rate, or the felt cost of living increases. I would be very interested in your comment on that.

Mr Stevens—I will get Phil to talk to you a little bit about cost of living indexes other than the CPI, because there are some. Let me offer perhaps one observation, though. Different groups will be facing, even within the CPI basket, slightly different outcomes. People do, though, tend to overlook prices that fall a little bit and 30 per cent of the CPI items actually had a negative price change in the latest quarter. There are certain things that people do not buy quite as often as the weekly groceries and it is human nature that we tend to forget that those prices go down in many instances. So I think that is a factor and it is understandable. But, in the end, the consumer price index samples 100,000 prices every quarter. There is a far better sampling there than any of us could do by keeping a casual tab on our grocery bill—which we all do. Certain things are quite prominent, of course—petrol and things like that. But I think the CPI is probably amongst the most reliable statistics that the Bureau of Statistics puts out because, as I say, they do a very large sample. But there are differences in experience, because the CPI is calibrated for the average household living in a metropolitan area and none of us are actually quite average, are
we? Any given person, probably quite rightly, will find that, if they could measure their own basket exactly right, it would not be quite the average experience.

**Dr Lowe**—The ABS also publishes cost-of-living indices for different categories of people. The latest data we have there is only up to the September quarter, whereas the CPI is up to the December quarter. In the year to September the cost-of-living index for age pensioners was up 3.1 per cent; the CPI over that period was 2.8 per cent—a small difference. For other government transfer recipients it was up by a bit over four per cent. These measures are on a different analytical basis and they take account of the fact that the consumption bundles of different people are different. One of the reasons the felt CPI is higher than the actual CPI for many people—

**Mr STEPHEN JONES**—For those people on welfare benefits, what they are feeling is actually true by the sound of it.

**Dr Lowe**—Yes. The prices of many goods at the moment are declining. If you go through the CPI over the past year, you see that the price index for clothing is down six per cent, the price index for major household appliances is down four per cent, the price index for audiovisual equipment is down 18 per cent, the price index for furniture is down two per cent and the price index for linen, Manchester, is down around two per cent. Almost all the goods in the CPI are down quite significantly. I think many people, because they do not buy these goods on a regular basis and have in their mind a clear concept of what the actual price is for a shirt or some Manchester, do not feel price declines but they are real and they are happening. What people are noticing is the higher price of utilities in particular. The price index there is up roughly 10 per cent over the year and people really notice that when they get their electricity bill. That is affecting many people’s perceptions of what the true cost of living is doing.

**Mr STEPHEN JONES**—There was an exchange between me and the Governor at the last hearing on utilities. I think, Governor, without wanting to put words in your mouth, you made the observation that some of the price increases we are experiencing at the moment in relation to utilities are due to a decade or more of under investment. You will correct me if I am wrong.

**Mr Stevens**—I think that is right. I think utilities prices were flattering us for some years and we are now paying that back, in a sense. We have to help pay for the capacity expansions that we need.

**Mr STEPHEN JONES**—I am interested in the opinions of any of the representatives on what you think is going to rectify that underinvestment, what risks there are to future investment, particularly in the electricity industry and what will stimulate and what will inhibit the necessary level of investment in that sector.

**Mr Stevens**—I would not claim to be highly expert in the economics of water and electricity. You can think of a few things that are relevant, one of which is that they need to be able to get a price for their product which covers their capital costs and returns. I imagine people will say that carbon pricing and all the things around that are going to be an issue. I cannot tell you what the right thing to do is though. It is an obvious thing which they will be thinking about in that industry—the cost of inputs, whether coal or gas are becoming expensive. All those things matter. In the end, we have to pay for the cost of the production and distribution of the power
and water we use. I do not think we will get an efficient allocation or usage of those things if we do not price them right.

**Dr Lowe**—The major price increases that we are experiencing at the moment for electricity are not coming about because of higher generation costs. They are coming about because of the investment in the distribution network. One of the things that have happened over time is that not only demand for electricity has grown but the spikiness of electricity demand has grown as more and more people have got air conditioning. We have not built enough transmission infrastructure to deal with those spikes. So the electricity authorities are having to spend a huge amount of money building the transmission or rebuilding and repairing and expanding the transmission network. We have not seen, at least to date, large increases in utility prices come primarily from generation costs. In time I think we will, but at the moment it is really about the networking, the distribution expansion that is going on.

**Mr STEPHEN JONES**—My final question goes to some of the observations in the SMP on inflation outlook for year end. You make the point that non-tradable items with particular contributions from rent, utility and other housing costs are feeding into your inflation expectations. My concern, which I would like your comment on, is that monetary policy is probably a pretty blunt and, if I dare say so, an ineffective instrument to deal with what are essentially supply-side shortages. In fact they could be counterproductive in dealing with those price increase expectations.

**Mr Stevens**—The argument about what causes particular price rises and whether it is supply and demand or demand—

**Mr STEPHEN JONES**—I think in relation to housing it can be beyond doubt that it is a supply-side issue.

**Mr Stevens**—It is an important point. But at some very broad level it is demand. Demand has been rising for electricity, and capacity to supply, until recently at least, has tended to struggle to keep up, for various reasons. It appears that to keep the supply growing at the rate we are demanding there needs to be higher prices to justify the various investments in networking and so on. You could argue that this is some supply problem and possibly it is temporary and therefore we should look through it, but I think you could also argue that really it is demand. Ultimately, at the current prices, demand has been growing very fast, and those prices are rising to reflect that in some very broad sense.

**CHAIR**—We will suspend this hearing for a short time.

**Proceedings suspended from 10.48 am to 11.02 am**

**Dr LEIGH**—In the latest *Statement on monetary policy* you discuss the increase to the household savings rate to around 10 per cent of household disposable income. The statement notes that this is a puzzle and seems to suggest that it is primarily due to a rise in risk aversion by Australian households. Given the magnitude of the increase, do you think that explanation is reasonable or could it be that monetary policy is overly tight? As a follow-up question, isn’t there a risk that, if this new found conservatism of households grows, it could exacerbate the gap between the mining sector and the rest of the economy?
Mr Stevens—I do not think monetary policy is overly tight. Certainly I think savers are looking for a reasonable return on their saving. People are inclined to pay off their loans a bit faster. It could be that that is related to continual talk of interest rates going up, which we seem to have. We do not seek to contribute to that talk—we try to be fairly circumspect about what we say—but that could be a factor.

My sense is that there is a change in attitude that goes beyond what the short-run path of monetary policy is doing, because we see this attempted change in saving attitudes and different attitudes to consumption and debt in a whole range of countries, even ones where interest rates are much lower than here. So, in seeking explanations, we should not look only at home.

For reasons I am not sure I can articulate entirely satisfactorily, I think people have just changed their view about saving, borrowing and consuming. It is, as the statement says, one of the key areas that we are uncertain about—whether that will continue to the same extent. I think the statement says—doesn’t it, Phil?—that you can imagine scenarios where this caution could abate and you can imagine ones where it could grow. That is a dimension of the outlook that we are uncertain about. If it continues in the way it presently is, I would have to say that I think that makes the task of managing the effects of the build-up in business investment that we think we are seeing easier for us—that is, interest rates are lower than they would have been had households been a lot less cautious. If they got really, really cautious then I suppose it is conceivable that you could imagine a scenario where interest rates might go down. I do not think that will happen, but you cannot say for sure that it will not. Likewise, it will turn out to be pretty unusual, I think, if we go through an event of this size the whole way and households do not pick up some spending at some point. That could happen. We are assuming a little bit of ongoing caution for a little while yet. But if there is no rise in household spending at all as result of the income boost that is coming, that will be a pretty unusual outcome historically. We have to give some weight to the things we can distil from history, obviously.

Dr LEIGH—Turning to the labour market, it looks to me as though there has been an outward shift in the Beveridge curve. Is that your read of the data? If so, what do you think is the explanation?

Mr Stevens—Do you mean that the relationship between vacancies and unemployment is deteriorating or improving?

Dr LEIGH—Deteriorating. For example, if you simply take the ratio of the vacancy rate to the unemployment rate historically you get a number of about 0.15. Now you get a number of about 0.4. Is that your read of the data? Is that a source of concern for you?

Mr Stevens—Is that more vacancies per unemployed person or fewer?

Dr LEIGH—There appear to be more vacancies per unemployed person than has historically been the case, at least from my read of the data.

Mr Stevens—The vacancy rate as a share of the labour force is on the way up. It depends on which measure you use. The ABS measure is quite high and unemployment is low, so that is right. Is that a problem? Taken at face value, it signifies a certain degree of labour market tightness. One might say as a result of all that that we are pretty close to full employment. At one
level that is good, isn’t it? We are supposed to try to have full employment. We do not want to be over full, so we do not want to have serious pressure on wages and inflation. We do not want to have serious skill mismatch, which might be another issue to talk about. I must admit that I do not think about it in Beveridge curve terminology, but our assessment of the labour market is that it has been tightening. Probably the pace of employment growth is slowing down a little bit. That is our assessment. Nonetheless, unemployment has tended to trend down a little over the past year, and probably that will continue over the next couple of years, which is why we have to be alert to potential pressures.

**Dr LEIGH**—So you are not concerned with issues of mismatch, be they geographic or skills based?

**Mr Stevens**—Dr Lowe can correct me if I am wrong, but I think what our liaison is telling us is that the resource guys and the people who are maybe doing some of the construction build-up associated with that and one or two other inputs are the people saying, ‘We’re starting to struggle getting the labour we want.’ I think most other firms at this point are saying, ‘Things have tightened up somewhat but we’re not really finding serious problems just yet.’

**Dr Lowe**—I think one of the things happening is that there are a lot of job vacancies out there, as you say, but when we talk to firms we are not detecting that they are having to compete incredibly aggressively to get workers to fill those jobs. If you go back to 2007, when the vacancy rate was high as well, we were hearing a lot of stories when we were talking to businesses that it was very hard to get the workers and you had to offer very attractive terms to get them. The vacancy rate is again high, but we are not hearing the same aggressive bidding for labour that we were previously. Firms are happy to take a bit more time and they can find the workers they want at the moment. Things are tightening up and have tightened up a lot in some sectors, particularly, as the governor said, the resources sector, but overall, even though the vacancy rate is high, firms do not seem to be saying that it is particularly hard to find workers at the moment.

**Dr LEIGH**—Turning now to one of the issues before us, can I ask you to compare market mechanisms for abating carbon pollution with non-market mechanisms. Given the same level of abatement, which of those approaches is likely to have a more adverse effect on growth and productivity?

**Mr Stevens**—You can ask me about carbon pricing; I am not sure I can give you a very well-informed answer, though, because I am not an expert in it. I would be prepared to say that, if the problem is as large as the experts believe, I think we are going to find that you want to probably have a range of techniques working to deal with it, one of which would be to try to harness market forces. But I am not sure that I can say much more than that, because I just do not know enough about the science or economics of climate change. There is enough controversy with the things I do know about, so I will stick to them.

**Dr LEIGH**—Moving on to foreign exchange, there is a chart on page 27 of the latest RBA chart pack that shows net purchases of foreign exchange and seems to suggest that, in general, the bank tends to lean slightly against the wind, purchasing foreign exchange as the Australian dollar strengthens. But that seems to have ceased in the last six months. Why is that?
Mr Stevens—We typically are not seeking to do intervention either way just at the moment. The history here in the broad is that, when the currency fell very sharply, there were moments of very disorderly conditions and we intervened to purchase Australian dollars and sell foreign exchange. Then at a certain point in time the exchange rate stabilised and began to recover. During that recovery period, what we normally look to do, once it is clearly going back towards average, is try to return the reserve position back to average as well. We are then repositioned for events either way that might come. Once that is done, the transactions to do it, of course, cease. I do not have before me the precise numbers on a month-to-month basis, but we are not seeking at this point in time to accumulate extra foreign reserves, so there are no measured intervention style transactions going on. We are content with the current reserve holdings.

Dr LEIGH—What is the underlying philosophy of your foreign exchange transactions?

Mr Stevens—The philosophy is: in moments of exchange rate extremes relative to our best assessment of fundamentals, and if in addition to that we have very disorderly markets, we will be prepared to intervene. On those occasions we have been prepared a number of times over the years to intervene with great force, but we are not frequent interveners. Those episodes do not happen often. Once they are over, if we have used up a lot of reserves we will think that was the right thing to do, but then we seek to return the reserve balance to normal.

There is not a lot of science around what is ‘normal’, but, Ric, I think that over the years we have felt that, if it was half the balance sheet, that is not a target, but—

Mr Battellino—Yes.

Mr Stevens—to have all our balance sheet in reserves—or almost none of it—is very unusual. We would think that was odd. We would seek to adjust back towards more normal holdings without wanting to actually move the price in the process of doing that, and there are ways of doing it that do not have much price impact. So that is the philosophy—we are not frequent interveners and we are not fine-tuners of the exchange rate, but if we think that there is a significant misalignment and disorderly markets we are prepared to act quite aggressively on those occasions, which are fairly few but have happened.

Dr LEIGH—Governor, where can I go to find the performance of the Reserve Bank’s foreign exchange transactions over time?

Mr Stevens—You mean the profitability or otherwise?

Dr LEIGH—Yes.

Mr Stevens—We have published some RDPs on that over time. They will be on the website, but we could make sure you get the links. The accounting profit and loss, of course, is in our annual accounts, and that is a very large accounting loss in the recent year because of the valuation effect of the exchange rate going up. As you know, we have to hold a large open position. That is our job because we hold the reserves, and that means we get big valuation swings. So all that is accounted under standard international financial reporting standards in the annual accounts.
Dr LEIGH—This is my final question, Governor. Mr Battellino made some comments last year that other countries have taken up to 20 years to move through the development phase that China and India are going through. Do you foresee that China and India will continue to grow strongly for some time yet? Feel free to defer to the man himself.

Mr Stevens—I will leave it to you, Ric.

Mr Battellino—It is really based on a graph that Phil did, so I will pass it to him! Seriously, when you look at these phases of development that countries go through, it takes a reasonable amount of time for countries to work through those phases. It would be wrong to assume that there is going to be an uninterrupted trend in one direction. These countries continue to have cycles, but the point is that, as they go through those cycles and that development, the demand for resources is elevated relative to where it was in the previous period. China and India will continue to have economic cycles, and that is something that we have to take into account in managing our economy. But, on balance, history would suggest that their demand for resources on average is going to be relatively elevated for some time yet.

Ms O’DWYER—Governor, I am keen to follow up on the CPI discussion and comments that we had earlier. In particular, the Treasurer has given the RBA a consumer price inflation target of between two and three per cent on average over the cycle. As a result of that, it is widely believed that the RBA has a target range of around 2.5 per cent throughout the cycle. Many of the other countries have lower implied CPI targets of less than two per cent—countries such as Canada, Britain, New Zealand and the US and Europe. I am interested in your explanation as to why it is that Australia seems to have a higher inflation target than these other countries.

Mr Stevens—There is quite a lot of history here. As you know, the present Treasurer does endorse the target, and so did the previous Treasurer. Indeed, the bank really began articulating this notion as far back as about 1993. I think it is true that, as you say, a number of other countries have lower targets. Some have higher targets—many emerging or developing countries have higher figures than we do—but the typical number for those who have a formal target amongst advanced countries is probably a fraction lower. It is only a fraction, but it is nonetheless a little bit lower.

Regarding the history of how we got to this set of numbers, in all honesty—and I was pretty involved in this—we got to two per cent in the early nineties as a result of a big fall in inflation that happened during the recession then. It did not look like we were going any lower. We had eight per cent inflation on average for 20 years. I certainly felt, and I think this was held in the bank generally, that, if we could hold somewhere near that, that was going to be a quantum jump in performance compared to the history. We should not over-promise and state exactly two, because that was reached in the depths of quite a deep recession. We should accept that there would probably be a little bit of upward movement as recovery proceeds, but keep the number under three on average. The other thing is, if you went back and looked at price-stability countries par excellence in the post-war period—Germany and Switzerland—they had a two-point-something average, as I recall. My thinking was, ‘That is pretty good. If we could do that, that would be a very good outcome.’ That is basically where this two-to-three came from. So far, over 18 years, I think the average performance was not quite exactly 2.5 but it is very close, so we have achieved what we wanted to do.
Ms O’DWYER—I might very respectfully point to those figures, on average, over the last 11 years. Headline inflation on average since January 2000 in Australia has been 3.1 per cent per annum, which is well above the 2.5 per cent target. Core inflation has averaged at around three per cent during that period as well. It is a long period of time and it covers multiple cycles, obviously. My question is: why has the RBA failed to meet its inflation target over that period? And do you think that the average three per cent inflation rate over the last 11 years has affected the RBA’s inflation fighting credibility?

Mr Stevens—I do not think it has affected credibility. I think most measures that I would look at there look okay, in terms of credibility. We had a big inflation episode in late 2007-08 and we had to respond to that quite forcefully. We did and inflation has come down again after that episode to about 2¼ most recently on the core and about 2¾ with the tax impact doing a little bit of that work on headline CPI. It would have been even better if we could have totally headed off that surge in inflation, but we could not. People can criticise us for having rates too low back in 2005, 2006 and 2007 if they want to, I suppose, but we responded to those developments and inflation is back under control. That is the job we promised to do. An inflation-targeting central bank has to say at any point in time that, as best we can tell in anticipation, things are going to be consistent with our target, and if they start to move in a way that looks like it is not consistent then we should respond to that. We have been responding to that. We have a fair degree of confidence that, with the right policies, we will achieve a two-point-something performance on average into the future.

Ms O’DWYER—I turn to a different topic: bank funding. Governor, can you please advise the committee on the RBA’s current understanding of the funding composition of the banks—a split between retail deposits and wholesale funding sources? Of those wholesale funding sources, approximately how much would be sourced from overseas?

Mr Stevens—There are about 60 per cent deposits.

Mr Battellino—It is about 50. So, roughly speaking, for the major banks, about half their funding is coming from deposits, about a quarter is coming from long-term wholesale debt—long-term bonds—and the rest is coming mainly from short-term debt, equity and securitisation. There has been a reasonable change in those compositions over the last few years, because banks, pressured by the supervisor, have been much keener to increase their use of deposits and long-term debt, and that is what has happened. The problem for the banks is that both those forms of funding that the supervisor is pushing towards are relatively expensive, and that has on average pushed up their cost of funds.

Ms O’DWYER—You can tell I am a student of history, and I do like to go back and look back. Did the introduction of compulsory superannuation in 1992 have a long-run impact on the source of funding for the Australian banking system? I am asking this because the IMF said in 2008:

A significant increase in banks reliance on wholesale funding occurred in the 1990s, driven by the combination of strong credit growth and an erosion of banks traditional retail deposit base, which was due in large part to the shift in household finance assets to superannuation funds.

I am interested in your comment on that.
Mr Battellino—These things are difficult to prove one way or the other, but I think there probably is some evidence to suggest that there was a shift in the way households managed their savings. If you go back 40 years, most people held their savings as a deposit in a bank. With the growth of financial markets and financial deregulation—and I think the introduction of superannuation probably contributed to this, because people became more used to holding these sorts of investments—more and more of the money went into these sorts of funds rather than banks, and the banks in turn had to borrow that money back directly from the super funds as short-term wholesale debt. Or, they were to some extent countering the effect of the super funds from offshore. A typical super fund would have, say, 20 per cent of its money invested offshore. So the growth of the superannuation industry saw an increased leakage of household money into offshore markets through offshore equity investments, and the banks were in some ways bringing that money back home by borrowing money offshore.

You can construct a picture that makes all these things consistent. But what is cause and effect, you can never really prove that. But I think on the surface I would probably agree to some extent with that comment.

Ms O’Dwyer—Do you think it is a permanent, structural shift?

Mr Battellino—I think it is changing already. In the last six months or so we have seen a very big shift again in the way the Australian economy is being funded. The mining boom that is going on at the moment is really a boom in the big corporate part of the economy, and those corporations are funding themselves by bringing in money directly from offshore. Whereas in, say, the nineties or in the early part of this decade, a lot of the offshore capital coming into Australia was coming through the banking system, at the moment it is coming through corporations, particularly mining corporations. That is showing up domestically as bank deposits, and the banks in turn have therefore been able to scale back to some extent their use of offshore funding. In fact, in the last quarter or two, banks have been able to repay in net terms some of their offshore debt.

Ms O’Dwyer—I do not want to put words in your mouth, obviously, but in terms of the comments that you have made, you would agree broadly speaking with some of the IMF’s consistent warnings that the fact that the nation has got very, very significant superannuation savings of something like, I think, $1.3 trillion, has a direct impact on the Australian banking system in terms of its stability. Would you agree with that?

Mr Battellino—I think it was probably a factor. It changed the way banks funded themselves in that period. But these things keep evolving. As I say, already in the last year or so, things are changing again.

Ms O’Dwyer—I know you say they are changing, but would you agree with that broad statement that significant superannuation savings has an impact on the stability of the Australian financial system?

Mr Battellino—Superannuation funds generally do not hold a lot of bank deposits, so the more household money goes into super funds, other things being equal—it is going to be harder for banks to fund themselves with deposits.
Mr Stevens—They are big providers of equity, though.

Mr Battellino—Yes.

Ms O’Dwyer—So, all things being equal, are there risks to the stability of the Australian financial system if, for instance, superannuation contributions are increased?

Mr Battellino—I am not sure I would extend the argument to that. The point too is the extent to which the banks were facing an increased risk by what they were doing. I myself have been always reasonably relaxed about the way the banks have funded themselves because, when you talk to the banks, they are very conservative. While they were borrowing money from offshore, every dollar of that was hedged both in the interest rates and in currencies. For them, it was really no different. Whether they were borrowing money from somebody in America or in Australia, the risk to them was exactly the same; it was hedged. So I think, yes, if you just looked at those raw numbers and equated offshore borrowing with risk, you would reach that conclusion, but if you look more deeply at the way it has all been managed I think those risks are probably overstated.

Ms O’Dwyer—So what is your view? Is yours the IMF view? Do you agree or not agree? You have given two—

Mr Battellino—No, I think I would agree with the IMF that the increase in superannuation and all the other things that happened in the wake of financial deregulation led to a change in the way in which banks fund themselves. Would I go the next step and say that that led to an increase in the riskiness of banks? No, I do not think so. I think all it did was change the way they fund themselves, and the banks continued to behave in a very prudent manner.

Ms O’Dwyer—The stability of the system then, rather than the increased risk with the banks?

Mr Battellino—On the stability of the system: we have just been through a very severe test of our stability and we came through with flying colours.

Ms O’Dwyer—I have one final question. I am interested in turning to another matter entirely now, Governor—that is, the composition of the Reserve Bank board. Because I know time is limited, I will paraphrase my question here, because I know that the board is made up of a number of different independent directors of different backgrounds and different skills. In the past, it has been the practice of independent members of the board such as Professor Adrian Pagan to contribute to the economic policy debate in their own right, given the specific nature of their economic skill set. Do you have a problem with board members contributing to the economic policy debate in their own independent right?

Mr Stevens—I have never had a problem with people who are economists for a living going about the things that are involved in being an economist for a living, which will include commenting on matters of public policy. It is agreed amongst the Reserve Bank board members that, on monetary policy, the spokesman for the board is the governor. That has been the case for many years. I think that system is understood and all the members are content with that. But our board members, even the ones that are not economists—most of them are people with a
commercial background, not an academic economics background—talk about all manner of things in their walks of life. How could it be otherwise? It should not be otherwise. Of course, when they say something, even if it is rather unrelated to anything to do with the Reserve Bank, the press always write it up as ‘Reserve Bank board member Mr So-and-so or Ms So-and-so says this’. That is what the press do, but they are not talking on behalf of the bank about those issues; they are giving their own view. I have not had a problem with that. The arrangement we have is that when the bank has to say something about monetary policy I or the deputy governor will say it, and I think that has been pretty much respected by the members.

Ms O'DWYER—I am happy with that.

Ms OWENS—Governor, can I go back to talking about savings and the increased caution. You have said today and in your statement that what is going on is not something that probably anybody in the world really understands yet; is that correct?

Mr Stevens—My point was that I think there is something happening in a number of countries, and therefore when we are thinking about why, there are no doubt some local factors here but it could be that there is a common factor, across a number of countries, that we should not neglect. That was my point. I think that in most countries the simple story is probably that households have had a terrible fright. They have learnt that, guess what, housing prices can fall, that having a lot of debt can be dangerous and that not saving anything out of your current income on the assumption that asset value going up is going to take care of your saving for you is possibly not a sustainable strategy. So they are changing behaviour, seeking to get debt down and save more and so on.

It might well be that one of the things that is at work in the households in our own country is that they have seen all of that in other countries. They have not suffered the same pain here, thank God, but many people will have said, ‘I think I am going to be a bit more cautious in future.’ This is an adjustment for the people who sell consumer goods. I understand that that is very tough, but I think in the long run we might be moving to a structure of household finances and saving that is a lot more robust to adverse shocks to income, which one day will hit us from somewhere. But I do not pretend to have a fully thought-out, fully articulated or provable set of hypotheses there. This is impressionistic, which is all it can be at this point.

Ms OWENS—So the bank is not doing research into changing spending and saving patterns?

Mr Stevens—We do a lot of liaison with the retail sector and we will I am sure be doing work on the sort of evolving structure of household finances but it is a fairly recent phenomenon. By recent I mean that it has been going on for some years but that is not a long time in economic data terms. So any research would be preliminary at this point. Is there any research you would like to refer to on this, Phil?

Dr Lowe—No. But I think we see lots of different parts of the economy telling us a similar story here. If you look at the use of credit cards, that has slowed down. The rate of payments on housing loans has sped up. You see it in the various consumer surveys where they ask people about their attitudes to spending and buying and there has clearly been a change there. You see it in the inflows into bank deposits, which have also increased. So there is enough circumstantial
evidence here to say that there is something fundamental going on. The more difficult issue for us is just how long this is going to last. It is pretty clear something has changed; it is just how persistent it is going to be. Are we going to soon forget about the global experience of the last couple of years and go back to spending most of the increase in our incomes or are we going to continue as we have for the past five years spending a relatively modest amount of the income growth that we have had. That is the thing that is very difficult to answer.

Ms OWENS—Is there a savings level or an attitude to spending that the Reserve Bank would consider to be a desirable level? Does it have a view?

Mr Stevens—I would be reluctant to give some figure that then becomes interpreted as a target to which we are trying to move, which would be the risk. But, let’s put it this way: we had quite a long period where household saving, the flow saving rate out of income, went down—as measured by the ABS it actually went negative because they take account of depreciation as well. But it was very low. So we were collectively saving nothing out of the current income. We were gearing up balance sheets to own houses, basically, and spending all of our current income. Historically, that is very unusual.

I am not one of the people who says that debt is always and everywhere a terrible thing. I have not said that. But people have picked up a fair bit of debt. A lot of that debt, a disproportionate chunk of it, is actually in the quite high income groups, not the really low income groups. Nonetheless, the community as a whole went, as we were talking earlier, from 60 per cent of income to 120 per cent, 130 per cent or some quite big number. They got to a point of saving nothing, at least as measured, out of the current flow of income. That could be perfectly rational for a time, maybe, but it does not sound like a position that you would be likely to be able to sustain for a long time without significant risk. You cannot keep gearing up indefinitely, and I think the gearing up is over now. The saving rate out of current income is now back at nine or 10 per cent. That is a lot more normal a figure historically. I am not saying it is necessarily optimal. We suspect it is closer, in some sense, to where we would expect it to be over the long run than zero, though.

Ms OWENS—in your consideration of interest rates, up and down, does the increased caution affect people’s response to interest rate rises?

Mr Stevens—that is hard to say. I think the increased caution has a bearing on what level interest rates turn out to be. It already has had an effect, I think, and, if it continues, that will continue to be so. It is harder to say whether, when there is actually a move, the new-found caution somehow gives a stronger response to any particular move. It is possible that it could be so. It would be very hard to prove one way or the other so far, though, I think.

Ms OWENS—This is a curious question, really. Is there a comparison between the way Australia as a community responds to changes in interest rates compared to the rest of the world?

Mr Stevens—you would expect that, if you have two countries and one of them is carrying a pretty high level of debt and one is not, a 25 basis point move in rates, assuming it is fully passed through to the rates that people save at and borrow at, will have a bigger impact, yes. That is one of the reasons why the rate moves are a lot smaller today than they once were when debt levels were lower.
Ms OWENS—You said earlier today that it is not always better that interest rates are lower, and you have said that a couple of times. Perhaps it is because most people talk about interest rate rises and not the other way around. Would you like to expand a little bit on why that is the case?

Mr Stevens—I think that one of the things that has been learned as a result of the global events in recent years is that, if you have a very long period of very low rates, what will happen is that people gear up. Financial institutions, having lent all the money to the prudent, sound borrowers that they can, end up looking for other borrowers, because their job is to lend money. I think many people would conclude today that the very long period of unusually low rates in the global economy, at least in the decade or half-decade leading up to the events that we have seen in the past three years, from the point of view of financial stability, was unhelpful.

There were a number of reasons that rates were low. One of them was that a number of major central banks kept their rates very low because they had unusually favourable combinations of growth and inflation and they felt that monetary policy should stay easy. But a whole lot of other rates which were not set by the central banks but set in the market were also quite low for various other reasons. So compensation for risk became very skinny and a lot of financial activity took place that turned out ex post—and it really should have been clearer ex ante—to be extremely risky. People were being given credit who really should not have got it, in the sense—that is not a moral judgment on them—that their capacity to service and repay simply was not there. That is what happened with a very lengthy period of low rates.

It seems to me that, when you look back, that is not a good outcome. That is why my feeling is that the presumption, which is often made in public discussion about interest rates in Australia, that with even lower—people used to ask us, ‘Japan has interest rates at zero. Why can’t we have that?’ We would not want it because the reason Japan had it is not something we want to go through and it is not, in its own right, a very good place to be for a lengthy period of time. That is the background to my comment.

Ms OWENS—Putting it in the context of a person who maybe bought their home last year when interest rates and cash rates were in the threes and now they are in the fours: is there anything in it for them?

Mr Stevens—Well imagine we had had the cash rate go to nothing. Then a lot more people would have borrowed at very cheap rates, but interest rates have to normalise one day, do not they? So there would have been a bigger task of normalising, I think. That is why I am not sure that an even lower set of rates than the ones we had would have been especially desirable, at least not for long. If it had been the right thing to cut them, we would have, but I for one am not unhappy that we did not need to go lower than we did. I know the people who took out loans at the bottom have seen any significant rise in borrowing costs. I can only say that we always said that rates would normalise when the right moment came and lenders are supposed to and as far as I know do test of people’s capacity to cope with a rise of a couple of hundred basis points. That should be done and as far as I know it is done. If it is not done, it should be.

Ms OWENS—We talked about the CPI briefly before and Dr Lowe referred to the analysis of CPI for various groups in the community, which was really interesting by the way. Different groups would have a different capacity to respond to CPI adjustment. Half a per cent is very
powerful for some groups and less powerful for others. Do you do research on the capacity to respond to that and the impact of those changes?

Mr Stevens—Do you mean the capacity of people to recoup a particular CPI increase that they face?

Ms OWENS—To adjust their spending patterns.

Mr Stevens—I am not aware of research to that level of detail that we have done it. Someone may have done it somewhere, but I do not think we have, not as far as I know.

Dr Lowe—No. You can look at various household surveys of expenditure and get some guide there. I think the general point here is that at the moment the price of food is rising pretty strongly and the prices of utilities are rising strongly. So people who spend a disproportionate amount of their income on food and utilities are finding things tougher than people who buy the full range of goods and services on a regular basis. The ability to substitute away from use of utilities and the consumption of food is very limited obviously. So those people have less scope to respond than people who are in a different financial situation. As to the research on that, it is hard to put that into hard numbers from some research methodology.

Ms OWENS—So the research is done more so that you can understand the move in CPI?

Dr Lowe—I would say it is kind of analytical, thinking about what substitution possibilities there are for different types of income earners. I think we have a broad understanding of what those possibilities are.

Ms OWENS—You said before also, Governor—again, the perception thing is very interesting to me—that as long as people believed that the change in the price of fruit, for example, was temporary, that would not feed into longer term inflation. Again for people who do not really understand what that means, could you explain how a belief in a price change would feed into something?

Mr Stevens—The simplest way would be: suppose that wage earners felt that inflation is permanently higher, therefore they need a higher pace of wage growth. That then pushes up costs, which makes inflation permanently higher. That is what we want to avoid. The key insight here is that if you take bananas—it is not all about bananas, obviously, but take that as an example—there will be, let’s say, a trebling or a very large increase in the price of bananas but, in two years from now, I would expect the price of bananas to be roughly the same in dollars as it was before the cyclone came because the crops will recover, the overall costs of production will probably not have changed that much and so the price level for bananas will go up and then down. The inflation rate on an annual basis of the price of bananas will go up, above normal, and then it will go below normal when the price fall comes and then back to normal. But, in the end, people do not need a higher wage for higher banana prices persistently because they will end up at the same place they started. That is the kind of idea we are trying to articulate and of course that holds for the whole range of fruit and vegetable and food prices in general. They should end up at approximately the same level as they were before and therefore we do not need the whole wage structure of the economy to inflate, because that would be a permanent impost in response to a temporary problem.
Ms OWENS—Given the extraordinary power an individual’s response has, are you happy with the level of understanding in the community of economics and how the behaviour affects the broader circumstances in which people live?

Mr Stevens—I think most people would say that the general community here are rather more aware of and have an understanding of economic issues than many of their counterparts in other countries. Perhaps that is a reflection of the extent of economic coverage in our media or maybe the extent of the coverage is a reflection of the level of interest. Who knows? Or maybe the causality runs both ways. But my observation would be that, compared with communities elsewhere we get more focus on economic news. Certainly, the Reserve Bank gets more coverage than our counterparts, the central banks, do in the average media in their countries. That is very observable. I think we get too much coverage, really, to be honest—more than we should—but that is just my view. I think there is a lot of economic coverage in our media. There are certainly some very capable journalists writing about these things, so for the person who wants to understand—I am often frustrated by the way things are explained; maybe I would not have explained them quite that way—I have to say that, overall, there is a great deal of interest and a fairly good level of understanding of these issues in the community. We always have the job, though, of explaining clearly and simply some of these issues. That is a task before us but that can be managed.

Mr BUCHHOLZ—I just want to have a quick chat about the multitiered economy and then about the flood crisis. It would be good if we could touch on some global commodity prices and inflationary issues and then finish off with equity in the banking sector. As I mentioned the last time we got to catch up, I have grave concerns about the tier of the economy that is subsequently doing it the toughest. We have a resources sector which is extremely strong, with unprecedented capital expenditure coming online, but interest rate movements will have very little dampening effects on the resources sector. What it will actually do is magnify and hurt the most disadvantaged. Are interest rates a blunt instrument right across the economy?

Mr Stevens—People always say that they are a blunt instrument and I think that is right in the sense that we cannot set a different interest rate for each person here according to their circumstances. It does not work that way; it is a market price that we move. That has always been true and always will be. There are actually not very many sharp instruments of macroeconomic policy, really, when you think about it.

On the multispeed issue, I do not want in any way to diminish the differences that exist. They do exist. On many metrics the extent of differences in some broad levels recently has not been very large compared with history. If you look at, say, the rate of unemployment in the 70-odd statistical regions we have, there are very few of those where it is double digit. The majority of them are under six and a significant proportion are actually under five. That is only one metric, of course, I know. But I think it is probably to be expected that the differences will be bigger over the few years ahead if the scenario we are all talking about does pan out. That is the case. Monetary policy cannot do anything other than try to set the right rate for the average, and none of us are really average, so none of us are going to find it exactly to our liking. I know that. There is nothing we can do to change that.

If we want to address regional differences or industry differences it has to be other policies that do that, and they are going to be in the preserve of governments in terms of spending...
measures, assistance measures and so on. It is going to be important though, I think, that those sorts of measures have a strong focus on helping people adjust rather than trying to prevent adjustment, because we are not going to be able to prevent at least some adjustment in the structure of the economy. I think we would not be well advised to try to do that, and I am not saying anyone is proposing that. It is those kinds of policies that have to try to cope with regional differences. By the standards of other countries which have a single monetary policy, or other regions, Australia has reasonable scope to do that if we want to use it. Those instruments of course are not in our hands—they are in the parliament’s hands, really.

**Mr BUCHHOLZ**—In Queensland we already have a king up there and we call him King Wally. Maybe we could have our own currency and our own Reserve Bank up there and import you up there and leave Ric here to run the show!

**Mr Stevens**—Well, this is an issue. I gave a speech on regional differences in Shepparton, where I went just after they had been flooded late last year. In principle, you can have your own currency. You have to have your own central bank. There are certain costs associated with doing that. I am not sure what would happen to Queensland’s exchange rate, though, because I think you would find that if there is a very large build-up in gas and mining, the Queensland exchange rate is going to go up, because the capital is going to flow into your region, which means that South-East Queensland and the tourism guys are going to suffer. In fact, your exchange rate could even be higher than the one we have now—I do not know. So you actually would want a different currency for regional Queensland versus urban, and now you are getting down to pretty small areas.

**Mr BUCHHOLZ**—I did not actually come in with that as a prepared question.

**Mr Stevens**—But the essence of the problem is that it is not just Queensland versus other bits of Australia. It is bits of Queensland versus other bits of Queensland, and ditto in Western Australia: urban versus—

**Mr BUCHHOLZ**—There is a huge disproportion between areas that rely on the resources sector and those that do not. The point I want to make sure that you guys absolutely have your head across—

**Mr Stevens**—No, we understand it.

**Mr BUCHHOLZ**—is that every time we shift that cash rate and interest rates move, my people up there bleed.

**Mr Stevens**—And I get emails telling me, believe me. Some of them are fairly frank.

**Mr BUCHHOLZ**—Yes, good work. With reference to the flood crisis up there, we have already thrown around figures—say, the economy will take a $7 billion or $8 billion hit. In the global financial crisis, in particular in the December 2008 quarter, I think GDP fell by $3.2 billion and we had some substantial stimulus that reflected that. Can you explain the difference between the seemingly disproportionate responses to the two hits?

**Mr Stevens**—We had a negative in GDP growth in one quarter, which has since been revised.
**Dr Lowe**—It is still negative.

**Mr Stevens**—It is still negative, but I cannot recall the exact number—half to one per cent; something like that. What we had in that episode was a slump in demand because everywhere in the world people looked at all those events—the collapse of Lehman, the stock market fell 25 per cent in a matter of weeks and governments were rescuing banks. It was an incredibly dramatic period. I hope never to live through anything like that again. Everywhere in the world, including here, people who were watching all this on TV thought, ‘Oh, gee, this is going to be terrible.’ Everyone hunkered down and so there was a shock to confidence, plans went on hold and demand slowed right down.

This one is a shocking event to the people involved, a supply event of capacity to supply coal, food and certain services as well. Many of those supply things will recover over the next six months or so. The overall demand track in the economy, I do not think, is going to be seriously affected. GDP is going to be a per cent lower than it would otherwise be. That is a big effect, but it is of a different nature to the one we had before. It is not a global financial crisis slump in demand and a total collapse in confidence everywhere. It is a different sort of—

**Mr BUCHHOLZ**—Can you expand on that for me why we will drop that one per cent in GDP.

**Mr Stevens**—A lot of it is through lost coal production. Coal was down already in December and will be further in the March quarter. We are saying there will be a 15 per cent decline, roughly, in national coal production as a result of the water in the pits and the rails being closed in the Queensland mines. In time, they will pump the water out. I think some of the railways are already well on the way to being ready to use. Ports are reopening and so that growth will come back. If we are right there, the June quarter GDP is going to get almost all of that one per cent back. That quarter will be a big plus.

**Mr BUCHHOLZ**—In the midst of going into that phase, we are going to be shifting to a position of growth coming back on, we are going to have a tax and yet we are still going to have a stimulus. Isn’t that a busy economy?

**Mr Stevens**—Do you mean the stimulus measures from the preceding program?

**Mr BUCHHOLZ**—Yes, from the previous one. They are still in place.

**Mr Stevens**—They are gradually tailing down through this period. That is the point.

**Mr BUCHHOLZ**—But they are still in place.

**Mr Stevens**—The rate of spending money went up, it plateaued and will come down over the next several quarters. So the federal programs—if the things go as they are scheduled to—those measures, are negatives on the growth rate over the next several quarters. They are a positive to the level of GDP but a negative in the quarterly change. The new spending is being accommodated at a federal level by slowing other spending, raising taxes.
Mr BUCHHOLZ—On your opening comments about the global commodity prices—the rest of the globe is dealing with inflationary issues and commodity prices—how do we differentiate or disentangle those commodity prices and assess the impact that it has on our inflation, plus trying to disseminate the flood sector as well?

Mr Stevens—It does have an impact. The floods are temporary. The interesting question about the broader commodity price rises globally is why is that happening? There is a kind of cyclical element but there is a structural trend going on because of the rise in the quantity of protein in the diet in China, and in many other countries, and the effect of that on grain prices because you use a lot more grain to feed a cow to get protein than you use if you just eat bread as a human. Those things are deep structural forces going on and it is raising the relative price level of commodities. In principle that ought to be a level shift but it goes on for some years.

Mr BUCHHOLZ—I have the gist of why the inflation is there but, when that hits our economy, how do we disentangle out what that proportion of inflation is in our statistics?

Mr Stevens—You cannot fully disentangle it, but you can look at the elements of prices where it has its most direct effect. The real question that you may be getting towards is: how does Australian monetary policy handle something that has a global origin? That is a good and very fair question. In principle, as a country that in the long run has an independent monetary policy with its own currency and a floating exchange rate, we are able to generally chart our long-run destiny ourselves but, of course, we have to let the exchange rate move to do that. Countries that import someone else’s monetary policy by pegging their currency do not chart their own destiny. Their destiny is set for them by the anchor country, but we are not in that position. We have our own currency area, our own monetary policy and our own inflation target. It makes it harder to contain inflation when you are getting these global shocks—that is certainly true—but we do a lot better than we would otherwise by allowing our currency to go up if it wants to and keeping the focus on controlling inflation over the medium term. That is going to be the best thing to do. It is not perfect but it is the best model there is that I know of.

Mr BUCHHOLZ—I just want to pick up on one of your comments earlier on with reference to the banks and equity. You said earlier that the return on equity in the banking sector has decreased over the last two years. But isn’t it true that the banks have increased the amount of equity that they have and that their risk is reduced, given the various government guarantees that they have been the beneficiaries of?

Mr Stevens—I think what has happened is that the return on equity went down in 2008-09. It remained positive, which is good. It has recovered, probably, most of the fall but maybe not quite all. So it is back to good levels. Banks have taken on new shareholder equity, so they have raised capital—not so much recently, but way back in late 2008 and 2009 they were able to get quite substantial amounts of equity, which was good. The wholesale guarantee—

Mr BUCHHOLZ—Wouldn’t that be a substantial reduction in their operating risk with the bank guarantee, and is that offset by their—

Mr Stevens—are they less risky now than they were?

Mr BUCHHOLZ—Yes. And there would be a cost associated with that.
Mr Stevens—I think their perception of the riskiness of some of their portfolio went up and has not come down again—so, for most business loans, this is the repricing that people have felt. That is the banks’ feeling: ‘Gee, the portfolio we are holding is more risky than we thought and we have to reprice for that risk.’ I think they would say that. I would say they are not hugely different on their risk perception on the housing portfolio.

They will have to hold a bit more capital as a result of the forthcoming Basel rules, although they have a long time to accumulate it. In some general sense there is a big argument here internationally between the bankers and the regulators, because the regulators want the banks to hold more capital. The banks want to say, in essence, ‘That means we have to have higher spreads because we have to pay for that capital,’ to which many of the regulators would say, ‘Actually you are less risky so your return on equity can be lower; therefore you do not have to have higher spreads.’ Who is going to be right there? We are not going to know for a while. The real issue is going to be: are the shareholders going to be content to accept lower and hopefully more stable returns on equity, particularly in the really big global banks that were quite risky over time? That is an interesting question to which we do not yet know the answer.

Mr BUCHHOLZ—I have one final question with reference to one of your other comments today. It was predominantly that you did not think that interest rates were going to move right now. Am I comfortable in assuming that that means 12 months?

Mr Stevens—I do not think I can give you a 12-month guarantee. What I said is that the market pricing at present has nothing much happening until quite late this year, which means they think nothing much is happening for some time. But nobody’s expectations about the end of the year can really be all that strongly held, frankly, at this stage. I would not want to say that that is an unreasonable set of expectations given the facts as we now know them. That is not a guarantee that nothing will happen, but I am fairly content with where we are at the moment. I think we are in a good position. I think we are ahead of the game, which is where you want to be. That is the thing that affords you periods of sitting, waiting and watching. Sometimes they can be reasonably lengthy periods.

Mr CIOBO—Governor, I would like to turn now to a different matter, the matter of Securency, in particular to clarify my understanding and to seek your comments on some aspects. As I understand it, Securency was 50 per cent owned by the Reserve Bank—

Mr Stevens—and still is.

Mr CIOBO—with plans to sell it, and 50 per cent by Innovia Films. Four of the board appointments are by the Reserve Bank and four of the appointments are by the other parent company. With respect to its operations, I understand that the Reserve Bank audit team undertook two audits—one in 2007 and one in 2008. Could you explain to me the first time that the Reserve Bank board became aware there might be an issue that required greater scrutiny? Can you give me a time line for that?

Mr Stevens—the time at which we became aware of the allegations that were made by the newspapers was when they were made. No-one in the Reserve Bank or on our board had ever had those allegations put to us before that time. They were very serious allegations, which is why the company took the steps it did at that time.
Mr CIOBO—I think the first media reports were in 2007, and I understand that the RBA audit teams were requested to undertake the audits by the Securency—

Mr Stevens—No. The allegations about Securency were made in 2009.

Mr Battellino—In May.

Mr Stevens—Yes, May.

Mr CIOBO—So why then would an audit team have gone in in 2007 if the first allegations came to light in 2009?

Mr Stevens—The audit team went there to do an audit of the policies and procedures concerning the use of agents.

Mr CIOBO—At the request of the Securency board?

Mr Stevens—Yes.

Mr CIOBO—Was that an issue of discussion for the Reserve Bank board at that stage or was it more—

Mr Stevens—After the issues with the Australian Wheat Board, I think every board in the country said, ‘Gee, we better just make sure that we’ve got strong procedures around these sorts of matters,’ and the Reserve Bank board did seek to do that. Securency were asked about their policies and procedures and the auditors went there to audit their procedures and compliance and so on.

Mr CIOBO—Was it at your direction or at the request of Securency?

Mr Stevens—Securency asked the auditors to go, but the Reserve Bank board—I’m right, aren’t I, Ric?—asked us, the management, ‘What are the policies in Securency and Note Printing Australia?’ They were provided with the relevant policies. I think that is correct.

Mr Battellino—Yes.

Mr Stevens—that would have been in 2006 and 2007.

Mr CIOBO—I understood it was 2007 and 2008. So you think it was 2006?

Mr Stevens—I am going on memory here.

Mr CIOBO—It followed AWB though?

Mr Stevens—Yes, that is right.
Mr CIOBO—You may not be able to answer these questions, and I appreciate if you don’t but I would be interested in your views subsequently though. With respect to my understanding of Securency’s operations, the OECD has put out several warning papers to companies about the use of overseas agents—and overseas agents were used fairly extensively by Securency—and outlined that corruption warning signs—as highlighted by the OECD—include using as an agent a foreign official that is a foreign official’s relative, friend or representative; using agents who do not provide any identifiable service; use of multiple agents for a single contract; use of corporate structures such as subsidiaries; use of beneficially held accounts, slush funds in offshore financial centres. Now it is my understanding that many of those practices were engaged in by Securency’s agents. In particular I draw upon KPMG’s findings to Securency. My own reading of the KPMG report into Securency as commissioned by Securency was that, whilst there were a number of written management processes and procedures in place, these were not effectively implemented by management and that, indeed, the board was largely unaware of some of the omissions with respect to the robustness of the enforcement of management policy. Have you got a view on that?

Mr Stevens—That is what the KPMG report found. It found that the use of agents is common, it is an acceptable practice and it has certain risks that need to be managed. It found that the company actually had on paper quite strong policies—and that is what the auditors, I think, also felt—but that the implementation of those had been weak, that there was not sufficient documentary evidence of compliance on the files and that the procedures needed to be strengthened in a whole bunch of ways. I think there were 12 recommendations, from memory, and my understanding is the company is in the process of implementing all of those at the moment. So that is what the report found.

In Mr CIOBO—And is that consistent with your view as the holding company?

Mr Stevens—I do not think I have got any basis on which to disagree with the KPMG findings there. I think they did a very thorough job and we in the bank accept the findings that they made.

Mr CIOBO—Has the Reserve Bank sought board minutes from Securency?

Mr Stevens—Our staff that are on the board have those minutes, obviously.

Mr CIOBO—But in their capacity as directors of Securency?

Mr Stevens—Yes.

Mr CIOBO—So I take it therefore the answer is no.

Mr Stevens—I do not know whether we have formally sought. Do you mean minutes of particular meetings?

Mr CIOBO—Yes, for the period.

Mr Stevens—I do not know the answer, I am sorry.
Mr CIOBO—Graeme Thompson, who was the chairman of Note Printing Australia—or may still be, I am not sure—and of Securency, stopped using agents following AWB’s corruption scandal in 2007. Yet Securency continued to use agents in a similar structure to that used by Note Printing Australia. Has the RBA looked into this or asked the board as to why NPA stopped using agents and Securency did not stop using agents?

Mr Stevens—The thing is that the structure was not similar. That is the difference.

Mr CIOBO—So what were the material differences, as you see them?

Mr Stevens—As a result of the AWB issues, there was some work done on the policies at NPA. The conclusion reached there was they were not adequate and, as part of some larger rethinking about the role of NPA anyway, the decision was taken that the use of agents would be ceased. That was on the basis that the company was going to focus in the future less on the international market and more fully on the existing customers. But also as for the procedures and policies in place there, when they were examined in the light of the knowledge of these issues that people came to after the AWB issues the conclusion was these policies were not good enough. So that was the reason for stopping the use of agents there. On paper the examination of the policies of Securency showed them to look pretty good. So they were not the same in policies, and that is the difference between the two experiences.

Mr CIOBO—So you are satisfied that the Securency board used appropriate due diligence with respect to ensuring that the management controls, as outlined by process, were in effect being used?

Mr Stevens—As far as I can see, I think the board members that were appointed from our side have acted properly; I am yet to see evidence to the contrary. But, as we know, it emerges as a result of the KPMG forensic audit, which was an incredibly detailed exercise, that policies that looked very good on paper—looked very strong and had all the right checks and balances and due diligence, and so on—had not been implemented properly. That is a fact; there is no doubt about that.

Mr CIOBO—Just to understand that: it would appear that the directors did exercise due diligence, then.

Mr Stevens—I have not seen evidence that they somehow failed in their duties. It is a bit early to say much more than that, because at this point a police investigation is underway; it is yet to be concluded whether or not illegal activities actually occurred. That is the claim, and it is a serious one that is being investigated, but the conclusion is not in yet.

Mr CIOBO—I understand it is the largest investigation the AFP currently has going.

Mr Stevens—I do not know if that is true or not.

Mr CIOBO—With respect to the commission payments: Securency policy said agents could only be paid one way, which was via a commission or a cut of the contract they helped Securency to win. I understand from KPMG’s study that about $46.2 million was paid in commissions. In many instances these commissions went to multiple agents; in many instances
they went to jurisdictions that were different to the one in which the agent was located; in their numerous instances, it is my understanding, again, from the KPMG report, that payments were made to multiple agents where it was unclear what work was undertaken. It is my understanding that, in many instances, although Securency was supposed to have a register of all payments made and the services for which those payments were being made, this was not, in fact, kept. All of these should be grounds for significant concern, shouldn’t they—that potentially Securency was paying corrupt officials in foreign countries?

Mr Stevens—All the things you said go to show that, as KPMG concluded, the documentation was inadequate—they did not have, apparently, the clarity on whether the guy they were paying had done what he was supposed to do, and so on. That is what not having the documents is about. It is a matter of concern that proper records are not kept, in any event, even if there were no improper payments. The company should have had better procedures or the procedures should have been implemented much more strongly than that, there is no doubt.

Mr CIOBO—We also have Securency using multiple agents to win contracts in Nigeria—for example: Joe Raad, Benoy Berry, Donald McArthur, Dave Marias, Michael Harding, and Paul and Amanda Whatley—some of whom would appear to have been involved in previous criminal activity, including arms dealing. These should have been matters of concern to the board, if they had been brought to the board’s attention or if the board had exercised due diligence, should they not?

Mr Stevens—I think in the most recent years and in the decade past the company had various due diligence procedures in place when agents were appointed. If it turns out that these people were engaged in illegal matters, either for us or elsewhere, and such procedures did not bring that to light, that obviously is a matter of concern. But I think, in fairness, the company’s board at least tried to ensure that there were proper procedures in place to do the due diligence. I think they made serious attempts to do that.

Mr CIOBO—What steps have been undertaken by the Reserve Bank subsequent to these allegations being raised, beyond simply the AFP undertaking an inquiry into anything that may be in contravention of Australian laws to ensure that there is now in place the required management controls?

Mr Stevens—A few things have happened that Securency has done. They called in the police, as you said, they commissioned the KPMG work and they have either already implemented or are in the process of completing the implementation of all those recommendations. From about September or October 2009, the agent arrangement was suspended anyway in all cases, I think, to review them and strengthen the procedures. That work is being done by the company. We support them in doing that. We would have insisted on nothing less had they not. So, for practical purposes, the agent arrangements are in suspension and are being worked through with a view to seeing which ones might be retained and which ones should not be. I do not know what the outcome of that process will be at this point. As far as the Reserve Bank is concerned, we have continued to insist that the company behaves in that fashion. We have lent any support to the AFP that they have asked for, as has Securency. We are examining ourselves. A question would be: is there any way that anyone in the RBA ever knew anything about anything? I am pretty sure the answer to that is no. Quite a bit of work is being done to go back through records.
You would expect us to do that and we have done that. It is being taken very seriously, I can assure you.

**CHAIR**—I have a couple of follow-up questions about some areas that were raised earlier. Ms O’Dwyer raised the issues of superannuation and stability. Putting it really bluntly and simply: do we have a stable banking system in Australia?

**Mr Stevens**—Let’s be clear: I do not think that the superannuation system or the proposed increases in superannuation contributions, which are supposed to occur in the future, make the banking system unstable. I would like to be clear about that.

**Ms O’Dwyer**—Could I just clarify one point. My question did not go to whether it made it unstable but whether it increased risks for stability.

**CHAIR**—You asked that question and I asked my question.

**Mr Stevens**—It is sometimes assumed that, because you have more types of wholesale funding, that is a less stable source of funding. It can be, although that usually occurs because there is something fundamentally wrong in the bank. The truth is that, when wholesale markets think that something is wrong, there probably is something wrong. So the main game is making sure that there is not something wrong. I come back to something Ric said. We have had a tremendous test of the system, and certainly government measures were helpful, but I think they were appropriate in the broad, given the global disaster that was unfolding, and the system has come through very strongly. You would not expect to see a more serious test than that very often.

**CHAIR**—The other area that I wanted to briefly follow up on is in relation to some questions from Mr Ciobo about wages and employment. Regarding the areas where there have been wages breakouts, I think you were saying that the resource sector was the key area where that was happening.

**Mr Stevens**—There is pressure on wages there. You would expect that. In the textbook, what you expect to see is the really strong sector bidding productive resources away from the other sectors. The way it does that is with the relative price, and the attractiveness of working or investing your capital in the mineral sector goes up and capital shifts and workers shift. That is what you would think would happen. It is not surprising that there is pressure. I do not think it is especially worrying in itself. The macro question really is: does that engender pressure right across the economy in due course that is too great or not? At the moment, I think we are travelling okay.

**CHAIR**—With the changes in industrial relations regulation, you have not seen any evidence of a wage break-out due to those changes?

**Mr Stevens**—What we have seen in some sectors is that retailers and others would say that things are a bit tougher in terms of employing various types of labour. I do not think we see a wage explosion there. The test will come as the labour market tightens—if it does, as we think it might—over the next couple of years. The question will be: do we come through that reasonably well, as I think we mostly did on the wage front two or three years back—do we come through as well as that with the changes in the regulations having been made in the interim? The
evidence is not really available to give an answer yet. We will find out, I imagine, over the next two or three years.

**CHAIR**—Governor, thank you for coming again and appearing in such a short period after the last appearance. We really do appreciate that and the time that you have given us today.

Resolved (on motion by Mr Ciobo):

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

*Committee adjourned at 12.32 pm*