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Members in attendance: Mr Bandt, Mr Buchholz, Mr Ciobo, Mr Jones, Dr Leigh, Ms O'Dwyer and Ms Owens.

Terms of reference for the inquiry:

To inquire into and report on:
Reserve Bank of Australia annual report 2010
WITNESSES

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

Committee met at 09:30

CHAIR (Ms Owens): I declare open this hearing of the House of Representatives Standing Committee on Economics and welcome representatives of the Reserve Bank, members of the public, media and students from Eltham College of Education and Trinity Grammar School. Despite the current international uncertainty, the fundamentals of the Australian economy are strong. Public debt and unemployment are low, and we have a significant pipeline of business investment, particularly in the resources sector. Some sectors, however, are under pressure as a result of the patchwork nature of the economy—the level of the Australian dollar in particular, as well as the cautious consumer. On the international front, while Chinese growth is solid, Europe's response has been tepid, and US debt problems have created uncertainty. The committee will question the governor on these and other risks to the global and national economy.

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

Mr Stevens: Thank you, Madam Chair. It is nice to be with the committee again here in Melbourne. Quite a bit has happened since we last met, in both the local and global economies, so I would like to talk about that. In February we had seen the Queensland floods, and Cyclone Yasi had just occurred at the time of our meeting. Tropical storms had also disrupted iron ore shipments out of Western Australia. There was understandably a focus on what the economic effects of these events would be. It was thought likely that economic activity as measured would be materially weaker in the March quarter than had earlier been expected but that there would be a recovery in the middle of the year. It was thought that the rebuilding efforts in Queensland would exert a mild expansionary impetus on demand in that state, beginning in the second half of the year.

GDP was indeed weak in the March quarter, with a fall in coal and iron ore production more than offsetting a modest rise in output in the rest of the economy. Since then the rebound in production of iron ore has been more or less as expected, and the disruption to general economic activity in Queensland associated with the floods has abated. But in the case of coal, largely for environmental reasons, the process of dewatering pits is taking longer than initially expected, so the recovery in coal production in Queensland is probably about two-thirds complete at this time. It may be early next year before production has fully recovered. This has had a material effect on forecasts for GDP.

It was also understood in February that there would be a large effect on the consumer price index because of the loss of key crops in the cyclones. These were expected to be temporary, and indeed prices for the relevant items are now starting to fall back as crops recover. The Reserve Bank has been clear that these fluctuations have had no implications for monetary policy.

What we did not know in February was that a serious Japanese earthquake would have a significant effect on global manufacturing production and sales, including in Australia's motor vehicle sector. This explains part of the apparent slowing in global growth in the June quarter. Part of the slowing in growth in the major countries is also likely to have been caused by the increase in energy prices in the first half of the year, which now appears gradually to be reversing. Another factor at work, though, has been the concerns raised about public debt in major countries. These were apparent six months ago, but they have escalated markedly in the intervening period. Not only did yields on the obligations issued by so-called peripheral euro area countries reach new highs, but interest rates faced by large countries like Spain and Italy also rose to levels that would have made their financial position much more difficult. The euro area's response to these issues has had some positive effects but it remains a work in progress. Meanwhile, the United States is having a very difficult time finding a path that avoids having to have an immediate major fiscal contraction but still puts the US fiscal accounts onto a sustainable medium-term trajectory.

As financial markets confronted all of this and also sought to digest a reappraisal of near-term global growth prospects, we have seen during August a period of intense turmoil, particularly in equity markets. The net result of this period is that equity prices in most markets around the world are anything from 15 to 25 per cent below their recent highs earlier in the year. Yields on long-term securities for the United States and the core European
countries have fallen to historical lows as investors sought safety, despite the US sovereign rating downgrade by S&P. Measures of volatility have increased sharply. There has been a degree of renewed pressure on US dollar funding for European banks. The currencies of certain countries regarded as safe havens, like Switzerland, have soared and the price of gold has reached new highs. So markets remain on edge.

All that said, the dislocation has not, on most common metrics, approached the extent that we saw three years ago. The main effect on Australia's financial markets has been lower equity prices, which have fallen along with those elsewhere. Other Australian markets for the most part have to date travelled fairly well in the circumstances. Funding costs if anything declined, which is being reflected in lower costs of fixed rate mortgages. Major Australian banks report being offered substantial US dollar funding in offshore markets on account of their relatively high credit standing, and that is quite a contrast to three years ago. In any event, their reliance on such wholesale funding is much reduced from three years ago, given the large increase in deposit funding at home and slower growth in balance sheets.

There has been no abnormal demand for liquidity by financial institutions from the Reserve Bank in this period, and the quantity of settlement funds in the system has been completely normal over the past month. The exchange rate has come off its peaks of a few months back, but it remains quite high compared to most of the post-float experience. Some commodity prices have declined, but at least at this point they have not slumped in the way they did in late 2008 and early 2009. Prices for major Australian commodities generally remain quite high.

People will understandably want to draw comparisons of this episode with the financial crisis in 2008. Of course, we cannot know what will transpire in the months ahead, but I think that what we have witnessed to date is best seen not so much as a new crisis but as part of the long aftermath of that earlier 2008 event. In the countries that were at the heart of that crisis, it was to be expected that after such serious problems in private balance sheets economic recovery would be a drawn out affair. That is usually the way with these things. This is having a predictable effect on the fiscal positions of the relevant countries—that is, revenues are weak and budget deficits have remained large.

It is not surprising that coping with that is politically difficult and it remains a point of considerable uncertainty what the ultimate resolutions in the major countries concerned are going to look like. This may well be leading to some precautionary behaviour in itself, and as a result of all these things the global growth outlook does not look as strong as it did six months ago, even though it is not necessarily as weak as some of the pessimists fear. In our own region, indicators suggest some moderation in growth in the Chinese economy, but it still appears to be still pretty solid. Around Asia, inflation rates have generally tended to rise in the past six months. A key question for the countries in the region is whether enough has been done to contain the inflation pressure, which does look to have spread beyond initial rises in food and energy prices. Asia's management of these challenges will ultimately matter a good deal for Australia and for the world.

In the meantime, Australia's terms of trade are very high and the investment expansion in the resources sector is proceeding. On all the indications available, it has quite some way to run yet. This is having positive spillovers to some parts of the economy. Our liaison suggests that, beyond the benefits being experienced by equipment hire, engineering, surveying and consulting firms, businesses as diverse as those supplying modular housing, laboratory services and training of semiskilled, trade and other workers are seeing effects of that minerals sector expansion.

Meanwhile, other sectors are being squeezed by the high exchange rate and by the much-touted household caution. I think it is important not to overstate the degree of caution. Some areas of household spending—for example, overseas travel—are growing very strongly. But overall it is, in my judgement, increasingly clear that we have seen a significant change in household behaviour. There was a lengthy period in which households saved progressively less out of current income, increased their leverage and enjoyed a sense of rising prosperity from the increase in asset values. That was most likely a one-time, if rather drawn out, adjustment to a number of important factors. It is understandable that it occurred. It should be equally understandable that it was not going to continue like that indefinitely. The new normal, so-called, which is actually the old normal, is where households save a non-trivial fraction of current income and keep their debt levels or their growth in debt levels more in line with growth of income. One positive that I think is worth noting here is that the adjustment to this new or old normal has been quite fast, which may mean that a lot of it may already have been accomplished. Nonetheless, in view of the financial turmoil of recent weeks, it would not be surprising if a degree of caution persisted for a while yet.

Three months ago, the Reserve Bank voiced concerns over the outlook for inflation in Australia, on the basis that measures of underlying inflation looked like they had ended a decline that had lasted for more than two years, were starting to turn up and were forecast to rise over the three-year forecast horizon. That outlook suggested that
policy would need to be tightened 'at some point'. The Reserve Bank did not have a precommitted notion of when that point might be. Those sorts of indications are, in any event, always contingent on the ongoing assessment of the outlook. The policy decision must of course consider not only the central forecast but also the possibility that things turn out differently to that central view.

In the intervening period, the international situation has become more clouded and evidence of caution at home has, if anything, intensified. Asset prices have declined, credit growth has moderated further and the exchange rate remains very high. All of these are affected by factors other than monetary policy, as well as by monetary policy, but together they suggest a fair degree of restraint is being exerted at the moment by financial conditions. Under those circumstances, the board judged that the most prudent course through this period was to sit still, in spite of inflation data that, on their face, continue to look concerning.

Looking ahead, the year-ended CPI inflation rate will probably remain well above three per cent in the September quarter. It is then likely to come down as the impact of last summer's floods on food prices continues to unwind. We will see, we think, the effects of that around the end of the year and into the early part of next year. After that, the assumed impact of the carbon-pricing scheme, which we have now put into the forecasts, starts to affect the headline inflation figures. I am being very clear here that the Reserve Bank will abstract from those carbon price impacts in setting monetary policy, just as we did with the implementation of the GST a decade ago.

It is the more persistent path of inflation on which the Reserve Bank must of course focus. In that regard, the question is whether recent events will have a bearing on that medium-term inflation outlook. It would be reasonable to anticipate that a decline in confidence, arising from the recent events internationally, may well dampen demand somewhat compared to the outlooks set out in our SMP forecasts earlier this month. That, together with the increased visibility of structural change in the economy, may also condition wage bargaining and price setting. If those forces persist, they may act to lessen the upward trend in inflation pressures that appeared to be in prospect. There are a number of maybes in those sentences. At the same time, significant rises in a range of administered prices are still set to occur over this period and unit costs have been rising quite quickly, given the fairly poor performance of multifactor productivity growth over recent years. So, as usual, there are varying forces operating in different directions about which the board will need to make careful judgments over the period ahead.

In summary, there is a heightened degree of uncertainty at present. That is stating the obvious. There are major challenges to the global economy and there are significant forces at work in the Australian economy. But, at this point in time, our terms of trade are very high while our unemployment rate remains low. Inflation bears careful watching, but I think we can keep it under control. Our banks are strong, our currency is sound and our sovereign credit position is in the international top tier. Consumer caution, while certainly making life hard for retailers, is building resilience in household balance sheets. And corporate balance sheets remain in quite good shape.

If we are entering another period of weaker international conditions, then I think that is a pretty good starting point from which to do so. Thank you, Madam Chair. We await your questions.

CHAIR: Thank you. In the statement following the Reserve Bank board meeting of 2 August, with quite a level of foresight the board judged that it was prudent to maintain the current setting of monetary policy in the light of acute sense of uncertainty in global financial markets. I note that, in some of your statements since then, you have used the word 'anxiety' as well, which would have been in relation to the US debt crisis as that unfolded. Do you now see that level of uncertainty has pulled back or are we still at that heightened level?

Mr Stevens: I do not think it has got worse. As I said, we have had a significant net fall in share prices and some other indications of some stresses, especially in Europe. Even this week we have still had some fairly significant volatility in equity markets internationally. Important as our proceedings are here to today, there is a speech by the US fed chairman tonight, our time, on which people are hanging. So I think there is still a bit of angst out there in international financial markets. That is partly because of the ongoing issues in Europe: how will they resolve these matters—and they are very, very difficult matters—and just what is the outlook for the US? Is the fed going to announce some further monetary stimulus?

Around Asia I would continue to think that actually prospects are still pretty good and economies are moving along quite smartly, particularly in China.

So the picture I think remains at this point more or less as I have outlined in the opening remarks. I do not think we could say right now that the anxiety has gone away. It is still there. There are going to be, I think, potential trigger points over the months ahead which might be to do with the US or with Greece or with the European stability mechanisms and so on, where markets will probably get anxious in the lead-up to those. I think the
European story—periodic bouts of uncertainty and anxiety—is probably going to be with us for a few years, actually.

CHAIR: As you said, there has been much talk about consumer caution and business confidence. Is the Australian experience fairly much reflective of what is happening internationally?

Mr Stevens: I think in a number of countries where we have had the run-up in leverage, the rise in house values and so on there has been a tendency for consumers to start saving more. The adjustment has been rather more painful, I would say, in, say, the United States or the UK than it has here. That is at least in part because those countries have not been enjoying the terms-of-trade experience that we are. In a sense, we have had households become considerably more prudent. They have been able to lift the saving rate here by, I think, 10 or 12 percentage points over several years. That is probably a bigger increase in that measure of saving than we have seen in comparable countries, and it is bigger than we have seen in past periods of our own history. There has been quite a bit of income growth in the economy that has helped that happen. So, yes, it is reflected elsewhere. It is happening here in, I would say, a more benign way because we have had income growth that other countries have not enjoyed.

CHAIR: You said quite recently—and you just alluded to it—that the rise in the rate of household savings is the biggest adjustment of its kind in the history of the quarterly national accounts. Is there a good side and a bad side to that from the Reserve Bank's perspective?

Mr Stevens: The bad side is if you are a retailer coming off that 15-year period of gearing up, with falling savings and higher spending. That was a long and good period for those parts of the economy that serve the consumer. It was not really normal—it was unusual, historically—but it was a fairly lengthy period. So I think it was quite an adjustment to come off that and into an environment where consumption is growing, but much more slowly than it was. I have said publicly that I was not one of the people who felt that the rise in debt was all going to end terribly.

Mr Stevens: I did not think that, but it did have to end at some point. At some point people reach a stage where they are feeling, 'I don't really want more debt; maybe I really ought to be thinking about some saving out of current income for the future.' There is a little bit more caution. Compared to going on as we were, that is going to leave household finances in a stronger position. That is good because someday, if there is a downturn, you do not want households to be excessively exposed in terms of their leverage when there is an adverse shock to income. So I think that is the good side of it.

I suppose one could also say that we are having a very substantial investment pick-up in the economy in aggregate. As we have all been saying, it is not evenly spread; it is concentrated. But we have an investment boom; it is actually not a bad thing to have some saving to help fund that. We do not have to fund it all ourselves; we can use the savings of foreigners—that is perfectly sensible. But to have some saving at home is probably not a bad thing. To the extent there is uncertainty about just how high national income really will be in the future, and that is uncertain—where will the terms of trade settle, and so on—reacting to the initial surge in income with: 'Let's not spend it all,' probably makes sense to a certain extent. That is the good side of it. As with most things in economics there are always two elements.

CHAIR: We do tend to focus on the downside sometimes.

Mr Stevens: I have noticed that.

CHAIR: I asked you once before, I think, whether the Reserve Bank had a view on what was a normal savings rate. At the time you said you did not really have one. You used the word 'normal' today, so I ask that question again.

Mr Stevens: It is hard to be doctrinaire about the optimal rate being X in theory. We should also take care with building very strong hypotheses on the saving rate per se, because it is inevitably not a very well measured aggregate—it is the residual. Quite a bit of the rise in saving actually came in one set of national account revisions a year or so back. With that caveat in mind, I think what was not normal was for a saving rate to be zero in gross terms or negative in net terms. That is very unusual, historically. As to where it is now: I think in a number of countries where we have had the run-up in leverage, the household saving rate is probably a bigger increase in that measure of saving than we have seen in comparable countries, and it is bigger than we have seen in past periods of our own history. There has been quite a bit of income growth in the economy that has helped that happen. So, yes, it is reflected elsewhere. It is happening here in, I would say, a more benign way because we have had income growth that other countries have not enjoyed.

CHAIR: Looking at one of your other comments, you remarked that our current terms of trade is probably the biggest gift that the global economy has given to Australia since the gold rush. If I am not in the mining sector, how is that a gift?

Mr Stevens: National income is higher. I know that people say they do not feel the effects of the mining boom—not everybody feels it directly, that is quite clear—but these income flows do flow around the economy. It
is very hard to be precise, but on the figuring that our staff have done, I think I can get Phil to speak to this in more detail, about half of that higher terms of trade revenue stays in Australia one way or another, be it through employment or profits that go into people's equity holdings, super funds, revenues to government and so on. I think that is about the figure.

**Dr Lowe:** Yes. The work we have done internally says that, over the past decade, for every dollar of extra revenue we have got in the resources sector around 10c is spent on domestic labour; around 25c is spent on buying domestic services, inputs into the resources sector; somewhere between 15c and 20c goes back to the state through royalties or taxation and somewhere between 5c and 10c goes to the domestic holders of the shares of the mining company. When you add all that up, somewhere between 50c and 60c of every extra dollar of income that comes into the country stays in the country, either in the form of taxation, profits or domestic services and labour.

**Mr Stevens:** And there is presumably flow-over from build-up in investment.

**Dr Lowe:** Absolutely, those are significant effects. Given that the terms of trade has doubled compared to what it was in the 2000s, there is a lot of extra income flowing around in the economy.

**CHAIR:** Can I talk briefly about the carbon price, which is estimated to have a one-off 0.7 per cent impact on inflation. The Reserve Bank has said that it will look through that, and you repeated that today. Could you explain why you would look through such an impact?

**Mr Stevens:** It is a public policy intervention, so to speak, to achieve a particular outcome. We had a restructuring of the taxation system a decade ago, with the GST, which raised the price level. It actually raised it more in the short term than the medium term. The medium-term effect was in the 2.0 to 2.5 per cent range, from memory. Then there was compensation to households for that, as there is going to be in the case of the carbon price. So, we feel that that is an identifiable thing that is not 'normal inflation'. It would not be right to tighten monetary policy in response to that.

The key thing will be to make sure that there are not ongoing significantly higher inflation rates resulting from that. There should not be if medium-term expectations of inflation remain anchored. If price and wage setters themselves look through the impact, seeing it for what it is, then so can we. I think the chances of that are pretty reasonable. I must admit that back at the time of the GST I personally worried that we might struggle there, but it actually worked out fine. The estimates that the Treasury came up with on the gross and net effects were, I think, pretty accurate. There was no lasting effect on inflation out of that and policy was able to look through it. It is to be hoped that that is the outcome here.

**CHAIR:** You said a very similar thing about the price of bananas after the cyclone—

**Mr Stevens:** Bananas are going to reverse, of course. The carbon price or the GST is a one-time lift in the level that is there forever but does not have an ongoing rate-of-change effect. The bananas are a rise in the level and then there is a fall, so the rate of change goes up and then it goes down below normal and then comes back up. It is typically the case that central banks will allow temporary supply side shocks to pass in and out of the data and not respond to them, provided that we keep expectations about future inflation well anchored. That of course is where the inflation target is so important.

**CHAIR:** I was referring to the perception side of the bananas and not the actual bananas—the much maligned banana, at the moment! The consumer caution side—the uncertainty, if you like, or the response of the Australian consumer to global conditions—seems to be very high. What would you say to Australians who look across Europe and the US and start worrying that Australia might be in a similar condition? Is the anxiety among Australian consumers overstated or stronger than it should be? Are there reasons why they should be?

**Mr Stevens:** In so far as the recent global turmoil is concerned it is natural; people read the papers and see the news. Bad news is usually very prominent in the media. So it is understandable that people would ask the question: are we badly exposed here? To that I would say that the sharemarket has been affected but, as I mentioned earlier, the vast bulk of the functioning of other markets here is largely unaffected. We do not obviously have anything like the sovereign debt issues that are confronting in Europe or America. These are terribly difficult issues to deal with. We do not have that problem. We do not have the problem of weak banks. The exposures of our banks to the troubled European periphery countries is trivially small, so there is no linkage there. And of course we as a country are still continuing to benefit from the increasing linkages with Asia. It is not as though we have switched totally and the US never matters any more and only China matters. It is not that at all. But there is a progressive reorientation of our trade—and I think that over the years we will increasingly see it in finance as well—to the part of the world where hundreds of millions of people are becoming affluent quickly. That is transforming the global economy and it poses challenges for us, as we have been reading. But it is also an
enormous opportunity. That is what I would say: by all means pay attention to these stories, but there are other much better stories that we must keep in mind.

CHAIR: I will go to a story which has not been so good since the mid-2000s, productivity growth. You have referred in a couple of your speeches to the fact that it has not been looking as good as it should be since about the mid-2000s. I assume that was part of a trend. I assume it did not happen quickly. Is that a case of good times making you a little bit fat, if you like?

Mr Stevens: It is not a conclusion I was that keen to draw myself for quite a while, but I think you cannot avoid concluding from all the figures we have that productivity growth has slowed. It has slowed in a number of countries, not just here. I think I would be right in saying that it probably seems more pronounced here. There is a story that says that some of this is the impact of the major build-up in capacity in mining—the productivity has fallen there but it will rise—and I think that is right. But the slowdown appears to exist in the bulk of the industry sectors, when you look at that data. It is hard to avoid it.

Why did it happen? I think I have said once or twice before that when times are good we do tend a little bit to not press as hard on some of those reforms as we might. I do not think there is any doubt that the period of maximum focus on productivity-enhancing measures and reforms was really in the period when the banana republic issues were being debated. There was not any alternative; we felt we had to do it and we did do it. It perhaps proves harder to do that when affluence has been better for a period of time. As I said recently in a talk, the thing we have rarely done is to try to work on improving productivity materially when the terms of trade are high, but if we could do that it would be a fabulous way to take advantage of the opportunities we have. Really, it is up to us as a country to try to do that. I do not have here in my papers the magic bullet of exactly how; it is not an easy matter. It is grinding, difficult and time-consuming work over a number of fronts over years. That is what it does.

CHAIR: Mr Ciobo.

Mr Ciobo: Thank you, Chair—well done on your first job as chair of the committee. Governor, I just want to touch on a couple of things. With respect to some of the challenges that the Reserve Bank currently faces, obviously there is a lot of commentary about not mutually exclusive but certainly areas of friction between two opposing forces: domestic inflation, which appears to be moderating perhaps over the medium term, and the eurozone debt crisis, for lack of a better term. Of these two competing factors, is one ranking more highly than the other in terms of the RBA's focus?

Mr Stevens: No. When I think about the 'international crisis' issues there are two dimensions. There are periods of tremendous turbulence when I think it is a very good thing for policy to just sit still, if it can, rather than add to that turbulence by starting to change our settings. You can only do that if you feel that you are in some sense ahead of the game on inflation, which I have felt. The other dimension, which is the thing to which I was alluding in the opening remarks, is what the impact of the turbulence will be, if any, on demand versus supply, and therefore prices. That is not going to happen immediately but over time. The issue we face is that the forecasts that were written down three months or a month ago have inflation not exploding but going up. Obviously we have to be concerned about that. Is it possible that what we have seen recently will amount to a diminution in demand pressures that will tend to cap that? That will be the question. It is too soon to know at the moment, but that is obviously a question we have to ask.

So you can, I think, build these various elements into, in a sense, ultimately what it means for the outlook for the economy and inflation and craft your response from there, keeping in mind that at times of extreme turbulence it is often a good idea to sit still, as a kind of tactical thing.

Mr Ciobo: Fundamentally you have eased from, effectively, an overall monetary policy setting to one that is slightly restrictive—I think that is your word. There has been a change over the past two years from the RBA.

Mr Stevens: The history, as you know, is that we eased very aggressively into the late 2008-early 2009 period because we felt that those events so fundamentally changed the world outlook, and I think that judgment was right. Then Australia came through better, really, than we had expected. As you know, we felt we should normalise, so to speak, our settings reasonably promptly thereafter. We are in a position of exerting a certain degree of restraint right now, mainly because, if you think about the biggest expansionary terms of trade shock for 150 years hitting the economy and inflation in core terms is okay but is not falling anymore, you would expect to be exerting a bit of restraint there. That is the logic of where we have been. I think that was right. Balancing the various forces and trying to work out what they mean for the outlook does not seem to be getting any easier right now, though. That is certainly true.
Mr CIOBO: Regarding the restoration of the federal government's budget position both domestically and abroad, we have seen massive deficits being the root cause of a lot of problems with respect to the Euro zone. In Australia we historically have not faced that situation. Can I ask for your view on the age-old question that we often discuss here: the trade-off between fiscal and monetary policy. How crucial is restoration of a surplus position in terms of the federal budget and its impact on monetary policy settings?

Mr Stevens: The projected return along with the unwinding of the stimulus measures, which is occurring more or less as it was designed to, is all part of the picture for the outlook that we try to put together. If that changed course materially, obviously that affects the outlook in some way—it could be in either direction, and we try to take account of that. It is built into what we are trying to do. It is very hard to do all that, of course, but we have to make the best estimate we can and monitor developments. The government said, I believe, that they will allow automatic stabilisers generally to work if the economy is stronger than expected. I think that is appropriate; that is a stabilising mechanism that is kind of built into the system—that is a good thing. I suppose the question they will have to ask is: if the automatic stabilisers work the other way if the economy is weaker, do they want to then do some discretionary tightening to meet a balance by a particular day. That is ultimately a fiscal policy call on which their advisers will give them advice. Whatever they do there, we would seek to adjust our thinking about the outlook accordingly.

Mr CIOBO: You have effectively answered, though, in a very reactionary sense rather than a proactive sense. I am trying to explore what your advice would be in terms of the best fiscal policy settings going forward to ensure that we do not allow inflation to put undue upward pressure on what is happening in the Australian economy.

Mr Stevens: It is hard to say. Yes, from an inflation point of view it is important that the unwind of the discretionary stimulus measures occurs, and it is occurring. They were designed that way, so that is appropriate. As to what the effects on inflation would be of a different fiscal-monetary mix, you have to factor in the exchange rate as well, so it is not a straightforward question to answer. But I think the key issues on the fiscal side are making sure we keep sound public finances over the medium term. You have to go back to balance and surplus, obviously, to do that. That has to be done. And—for the use of significant discretionary countercyclical measures—I guess I would counsel a reasonable amount of caution there, and I think that has been the approach in Australia over many years. There were discretionary measures at the height of the crisis. In a crisis of that nature that is fine. I think, though, that, absent crisis conditions, essentially devoting the fiscal side to issues of good structure of taxation, efficiency et cetera and sound public finances in the long run, which has been the approach historically, is a good approach in normal times.

Mr CIOBO: If I look at the differences between forecasts an actual outcomes—and you made references to this in your opening statement—I think the RBA predicted back in February for June of this year growth in GDP of 3¼ per cent. In May that was trimmed to 2¼ per cent and the actual was 1¼. For June next year GDP growth is forecast, as of February, when the prediction was made, to be 3¼ per cent. In May that was revised upwards to 4¼ per cent and I think Treasury forecasts are 4½ per cent. My question is this: given your focus is on medium-term inflation outlooks, and obviously GDP growth will be a major feature of that, and given Treasury forecasts are so optimistic and would almost appear to be perhaps out of touch with the reality of where things currently stand, is it a concern to you that we could see an ongoing budget deficit situation, and therefore that is something that you need to take into account with monetary policy settings?

Mr Stevens: If you suppose you saw weaker than expected activity and the budget took longer to go to surplus. That would be the automatic stabilisers working. There is nothing particularly wrong with that, actually. Most countries and most economists I think would accept that the automatic stabilisers should be allowed to work. Are we going to go and jack up rates were that to occur? No, I do not think so. It is not obvious to me that we would. If the economic activity was weak enough, you could conceive of a scenario where you might reduce them—I am not saying that will happen. But I do not think there is quite so mechanical a link to whether the budget gets to balance on a given day or not. It depends why the difference is occurring. If that was occurring because of a new round of discretionary stimulus, that is a different story. So it matters why the assumed event has occurred.

Mr CIOBO: Can I ask about the labour market. In particular, you made comments earlier in response to the chairman's question that implied for me—and this may be an incorrect assumption—that a large part of the inflation pressures we see are demand driven. I would have thought that the bulk of what we are seeing is supply side impact. You have previously made comments to this committee about business concerns over a lack of flexibility or reduced flexibility in terms of an industrial relations framework. I am just interested in your
comments and thoughts about the way in which this is having an impact on major price inflation and, in addition to that, your comments about the extent to which this is feeding into the slowdown in productivity.

**Mr Stevens:** In terms of demand versus supply inflation if you take as your starting point that there has been a material slowdown in productivity—if that is so—that is really saying in a way that the economy's capacity to supply the demand that we want to have is not what it used to be. You can say that is supply-side inflation in a way, but I think you can also say, and I would say, that that has to condition how much demand growth you think you can have. What you are really saying is that the economy's capacity under that hypothesis to grow at a certain rate without inflation has been impaired. What businesspeople say to me—and I think this would be a theme I have heard from a number of quarters—is not so much that wages are excessive and indeed at this point in time the aggregate data on wage growth which is probably furious, a touch under maybe, is on a par with what we have seen over the years. What people say to me, I cannot verify it obviously, from their individual businesses is that they find it harder to negotiate flexibility. That is something that is said. If that is true that I think is a matter for concern.

**Mr CIOBO:** In terms of the RBA's tolerance level for wage growth, historically it is a combination of productivity growth plus inflation. With a trimming of productivity growth does that mean that what is effectively NAIRU is higher?

**Mr Stevens:** I think what it means, if the hypothesis is that productivity growth is permanently lower, is that then the rate of nominal wage growth that everybody has been accustomed to will not be consistent with the inflation target any more unless some other factor is at work providing an offset. That factor could be a rise in currency but it would have to keep rising not just rise once. It is quite an important question. I would not pin this just on labour productivity, multifactor productivity generally has slowed down. It makes the Reserve Bank's job easier of course in controlling inflation but even apart from that it is in the interests of all of us for our future living standards to have the best productivity performance we can have because that is the source of growth in our living standards, there is not really any other source ultimately.

**Mr CIOBO:** I have a final question in terms of the effectiveness of monetary policy. This has been put to the committee by a number of commentators. If the source of inflation is predominantly coming from that 25 per cent of the economy experiencing a 15 or 16 per cent rate of growth—that is, the mining sector and associated industries—and 75 per cent of the Australian economy is growing at one per cent is monetary policy the best tool to curb inflation or are we better off looking at, for example, other alternatives like quantitative easing or perhaps reductions in government expenditure? What are your comments on those?

**Mr Stevens:** Quantitative easing is an easing of policy—I would expect that to increase inflation. If we look at the 100,000 prices that are in the CPI, aggregated into 100-odd expenditure classes, it is not actually mining that is pushing up most of those things directly. Prices of goods in the latest quarter rose surprisingly strongly, we thought, given the reports we had had about discounting. There may be a seasonality issue in the data there. Utilities prices are rising strongly. I think that is testimony to not enough investment in the network capacity and so on over a very long period of time. That is a supply side constraint that has to be addressed with higher revenues for the producers, so the administered prices are rising.

So I do not actually accept that all the inflation is in fact coming just out of mining. It is true that a lot of the growth and output comes from mining and all the parts of the economy that feed into it; it is not just mining itself. But what I think we do have, on our best estimates of abstracting from special factors and so on, is a bit more broad-based rise in prices. At least, it stopped falling and it looks as if it may be just starting to edge higher. I do not think that per se is directly just the mining stuff. Were it not for the high exchange rate, I think we would have more of this. Phil, do you want to add to that?

**Dr Lowe:** Yes. I think the underlying inflation pressures in the economy are really coming from this combination of relatively weak productivity growth and around average wage growth. That means that unit cost growth since the mid-2000s has been quite high. That has not led to a rising trend in inflation but it has led to fairly high inflation. It has been offset to some extent by the decline in manufactured prices. If you look at the CPI at the moment, the prices of many manufactured goods are lower than they were 10 years ago. That is the benefit of the high exchange rate, but the range of domestic services have been rising pretty solidly, and not just directly because of the mining sector but because of the growth in unit costs. That pressure, at least at the moment, does not seem to have gone away.

**Dr LEIGH:** Governor, I want to start if I may on the issue of inequality. You have written a lot about the impact of the mining boom: that quadrupling of commodity prices on the broader economy. But I suspect it is also likely that the mining boom has increased the gap between rich and poor in Australia. It is a trend we have seen for the last couple of decades. For example, Jeff Borland's paper at your conference last week showed that wage
growth for the top quintile of the distribution had been twice as fast as for the bottom quintile over the past decade. Obviously inequality means a larger share of Australian incomes are going to a smaller number of people, so I guess my question for a monetary policy maker is: do you aim with monetary policy to target the average dollar in Australia or the average person?

**Mr Stevens:** We aim to contain the growth in the CPI at between two and three per cent. That is supposed to be a reasonably representative index of cost of living, although there are other indexes, as you would know, that are more tailored to particular groups. But that is what we are trying to do; we are trying to preserve the purchasing power of money, and not particularly the purchasing power of the money of the richest or the poorest but the total.

**Dr LEIGH:** But you also have other aspects to your mandates around growth and full employment. Wouldn't those suggest that you should be placing some weight on the impact on the average person rather than just the average dollar in the economy?

**Mr Stevens:** Yes, we have in our statutory objectives full employment, stability of the currency and the general prosperity and welfare of the Australian people. Over the past year or so the unemployment rate has been five, plus or minus a tenth basically. I think, by the standards of the nearly 32 years that I have been working as a professional economist, that is a low number. Indeed, when I started at the Reserve Bank, the notion that you could have five-ish per cent unemployment and two-ish or three-ish per cent inflation was a dream in those days. My answer to the full employment question would be: I think the Reserve Bank has fulfilled that side of its mandate, recognising of course that a sustainable unemployment rate ultimately is a function of industrial relations matters, not monetary policy.

**Dr LEIGH:** Let me move to another issue. On the carbon price, inflationary expectations obviously matter. You have spoken here and in the recent statement on monetary policy about your expectations as to what the actual price effect of a carbon price will be on 1 July next year—0.7 per cent on the CPI and a quarter of a per cent on inflation for the 2012 year. But a number of pretty influential commentators—Peter Martin, Ross Gittins and Bill Evans—have suggested that the scare campaign that has been run around Australia in recent months has seen Australians' expectations about that price effect become completely out of whack with what Treasury and the RBA are predicting. For example, suggestions that towns will be wiped off the map and that petrol prices will rise are all presumably pretty unhelpful to the management of inflation expectations. What does the Reserve Bank do in instances where people are claiming that inflationary impacts will be different from what you believe they will be?

**Mr Stevens:** What we do not do is get into political debates over particular policies. What we do is keep focused on articulating our expectations and also monitoring actual measures of inflation expectations, which I think at the moment have probably, just in the last month or two, come down a little bit. I think at this point we are probably okay there. Ultimately people will see what the effect is and then it will be clear. It is only another year or so.

**Dr LEIGH:** Are you concerned if inflationary expectations about a particular policy change are different from what you believe they will be?

**Mr Stevens:** If it was a very big difference that was clearly having an effect on other price setting and wage setting, I think that would be a matter of concern. I have not seen evidence that is occurring at the present time.

**Dr LEIGH:** How would you react if you were to see that evidence?

**Mr Stevens:** It is hypothetical, isn't it. We have to keep stating what the facts are or what the best estimates are. We have to keep behaving ourselves consistently with our stated objectives and try to convey to those of the community who read what we say a reasoned estimate of these matters. But that is all we can do.

**Dr LEIGH:** On the measurement of inflation, there has been an argument recently that the ABS's fairly infrequent rebasing of the CPI has led to an upward bias in the CPI, maybe in the order of half a percentage point. Are you concerned about that? Are you tending to use, say, the household implicit deflator rather than the CPI because of that?

**Mr Stevens:** We are not doing the latter. Perhaps I will get Phil to talk to the technical aspects of the frequency of updating.

**Dr Lowe:** At the moment, the ABS does a survey once every six years to work out exactly what we are spending, what goods and services we are buying. So the weights get changed once every six years. I think the analysis that various people have done suggests that the fact that they only do that weighting once every six years does lead to a slight upward bias in the CPI, particularly towards the end of that six-year period, because what happens over time is that we all substitute towards the goods that are slightly cheaper and away from the goods
that are fairly expensive, so the true costs that we are actually paying for goods and services are not rising quite as quickly as the CPI. But the effect is fairly small. In most of the estimates I have seen, it is around 0.1 of one per cent.

The ABS in its most recent review says it would like to move to four-yearly reweighting. Then they would have to do a survey every four years of the population about what we are actually buying. That requires extra money. I think they are still seeking budgetary approval to do that. I think if we could go back to once every four years that would be a good thing to do, because that would allow them to capture the substitution towards cheaper goods that we all do from year to year. None of that really undermines the credibility of the CPI, though. This effect is there, but it is fairly small in the overall scheme of things.

Dr LEIGH: Governor, there have been a number of statements that you and others have made about the importance of pay being strongly related to productivity outcomes in the economy. In a context in which there has been some public comment on the salaries of Reserve Bank officials, this might be a useful opportunity for you to comment on your views on some of that commentary, changes in Reserve Bank salaries and the relativities to other central banks.

Mr Stevens: I am not sure I can help much there. I do not set my own pay. The board set it. They had quite a lengthy process of reviewing it after the system had been in place for many years. They took their decision, and I take what I am given, like anyone else in the country. I am not able to give you the whys and wherefores of whether that was an appropriate decision. I did not take it. I had no involvement in it.

Dr LEIGH: At our last meeting, you expressed some uncertainty as to what was driving the consumer caution in the economy at the moment. Do you have more views as to what is going on? Are there new things that have clarified your thinking around that issue?

Mr Stevens: From my own views, the most complete treatment I could offer is the Anika Foundation speech of a few weeks back, which tried to set out a number of the things we have been talking about here today in a historical setting. Just to reiterate the remarks I made at the beginning, we had a long period in which growth of spending exceeded growth of income every year on average by about a percentage point. So, if you drew the two lines of income and spending, spending was catching up. Saving fell, leverage increased, housing prices rose, wealth rose. Why did that occur? I think the best explanation is that we had a number of factors—you had financial liberalisation; you had Australian banks coming out of the early nineties recession with a few bruises from lending to corporates, but there were the households, undergeared really, by international standards anyway. You had a big decline in nominal interest rates because inflation went from an average of eight percent to an average of two or three. Nominal interest rates came down in parallel. The average level of nominal interest rates has been roughly half what it was in the high-inflation period. So banks are looking for customers to lend to, there are customers who have not had much gearing, partly because the high-inflation, high-interest rate period suppresses it, and then that is removed. Then there is a period of international economic stability, the so-called great moderation. That is now gone of course, but from probably the mid-90s through to the mid-part of this decade, at least, that was by all estimates of volatility a remarkably benign period for economic activity. There was low inflation, positive supply-side surprises and so on. That is a perfect environment for people to think it is sensible to have more debt: 'I can afford it, the bank wants to give it to me and so on.' There is nothing especially wrong with that, but when income and consumption do this sooner or later they are going to go back to parallel, which is roughly what they have done—actually they have diverged a little. As I said in the Anika Foundation talk, a trend of diverging income and consumption is not any more sustainable than the preceding trend. At some point it will give way to something different, but I do not know when. I think we can appeal of course to proximate things at the moment, be they debates about carbon, international turmoil, whatever. No doubt those things have their impacts, but the point I was trying to make in that talk is that this long, low-frequency thing has occurred. It is sort of superimposed on the short-run stuff, and it is superimposed on the resource boom as well. Those things are combining, but they have kind of come from different sources. As it happens, they are both in play at the moment. That, I suppose, is the longwinded answer to your question.

Dr LEIGH: That is very helpful, thank you.

CHAIR: Just to make you earn your coffee, some high-school students are going to ask some questions.

Aakash Kapoor: I am from Eltham College. How do you prioritise the economic goals other than inflation when considering changes in monetary policy stance?

Mr Stevens: This goes a little to the issues Mr Ciobo was raising earlier. We have a statutory goal of full employment, which is not defined in terms of numbers of unemployed, so there is an issue: we have to work out what that means numerically. There is also stable prices—we have to put a number on that too. Those two things
can in a sense be in conflict over short periods, but in the long run they are not actually in conflict. I would say that one of the main insights of macroeconomics in the period I have been following it is that the sustainable unemployment rate is ultimately determined by the set of systems in the labour market. Monetary policy can make it go away from that for a while, but not permanently. In the medium term and the long run, inflation is largely a monetary thing so provided our definition of full employment is consistent with what the real economy is telling us there is no inherent conflict between the two goals. Where there can be temporary difficulties is where you get a so-called adverse supply shock that pushes inflation up and activity down, in some countries that is what is happening now, but that is difficult. We have to take a reasonable and balanced path between the two when that occurs. I think that is as good as I can do on that. Thank you for the question.

Kartik Misra: I am from Trinity Grammar School. Mr Stephens, with a two-speed economy and the likelihood of a bout of Dutch disease, isn't monetary policy too blunt a tool to manage the Australian economy? So shouldn't the RBA just keep the rates neutral and let supply-side policy do the work?

Mr Stevens: Well, there are multiple speeds in the economy. That is actually always true. It is probably a bit more true now than on average. In the end, though, it is the central bank's job to try to preserve the value of money and promote financial stability. Supply-side policies can certainly help that or hinder it, depending on how they are operated, but we have to take supply-side policies as given and do our job of containing inflation pressure while taking account of the impact on the real economy. As I said earlier, right now the unemployment rate is around five, where it has been for a while; the inflation rate is a bit troubling but not out of control. I think from that overall point of view we are travelling okay. The differences in regions and industries are actually not things that monetary policy can fix. If they have to be fixed, that will need to be done by other arms of policy.

Kartik Misra: That's very much.

CHAIR: Thanks very much.

Proceedings suspended from 10:46 to 11:03

Ms O'DWYER: Governor, I thought the student from Trinity had a very good question before. So I am going to ask the obvious question. Do you believe that Australia is suffering from Dutch disease?

Mr Stevens: What is Dutch disease? I think that is a phenomenon where a rise in natural resource prices leads to a larger rise in the exchange rate, squeezes other sectors, and that is all temporary, and then you reverse. I think that is generally the definition. So the real question is: is what we are seeing temporary or persistent? We do not know, of course, and I have spoken about this at length a number of times publicly. If we are seeing just a temporary huge surge in the terms of trade and it is all going to collapse back to the 20th century trend, which is a long way lower than here—we are about 80 per cent above that trend at the moment—but if you knew that was going to occur then you would not restructure the economy in response to the shift in relative prices, or at least not much because it is costly to restructure and then it would be costly to restructure back. If it is permanent, if relative prices stay permanently altered in a significant way from where they used to be then we will get restructuring. We cannot actually stop it, I do not think. What we have to do is facilitate it and adapt to it and ease the transition.

Is it Dutch disease? I am not sure that it qualifies for that. Treasury had a very good piece on this in the budget papers. I am not sure if you saw that, but that is actually well worth a read.

Ms O'DWYER: If we are suffering from Dutch disease, are the areas to focus on fiscal policy or monetary policy?

Mr Stevens: Monetary policy cannot stop a phenomenon of structural change occurring. I do not know that fiscal policy can either, actually. My point is that if this really is a very persistent change in global relative prices, global structure, then we will be adjusting one way or another and we need to find ways of doing that that ease the difficulties for those who are getting smaller, obviously, and that goes to a whole bunch of things which probably do cost some public money. But I do not think fiscal policy per se can somehow make this adjustment go away.

Ms O'DWYER: Before in your testimony you mentioned the need for government to pursue reforms to drive productivity. Can you enlighten the committee again on your views on what we should focus on in terms of productivity? Have any areas become clearer to you since the last time you provided testimony here?

Mr Stevens: The problem, of course, with me saying productivity is important is people then say, 'Well, right, what should we do?' That is obviously the question. The best thing I can say in response is there is a body who spends all its time thinking about productivity, namely, the Productivity Commission, and their list of things is quite long: competition; efficient pricing of utilities and infrastructure—roads, rail, ports, water, energy; reducing inefficient regulation of major resource projects; zoning and planning restrictions; harmonising consumer,
industrial and building codes; reducing barriers to entry; improving competition in a range of industries, including various professions; harmonising licensing fees—and so on it goes.

I cannot do any better than say that there is a body that the taxpayer pays to think about this stuff all the time. They are going to be much better equipped than me to point their finger at specific things that can be done. None of those things are easy to do, of course, and they take time. And a lot of them require state-federal cooperation.

Ms O’DWYER: Focusing purely on financial system stability, are there policy matters which you believe Australia should have been addressing since the last financial crisis to better position for this one, or I think you described it more as a ‘lag’ today?

Mr Stevens: Are there policy measures in the financial stability area? I think that perhaps I could try to answer that by talking about what is actually going on. In this sphere there is, as you would know, a lot of international work. The thrust of that is more capital—particularly for the large global banks that were very highly leveraged and undercapitalised—and better quality capital. So there is the whole Basel 3 thing, and Australia will implement Basel 3. We have one or two unique challenges in implementing it but they will be met.

There is a range of work surrounding what I suppose you could describe as increasing the strength of financial infrastructure to do with clearing of derivatives and those kinds of things. Those also pose challenges for Australia and there is a work stream underway there under the auspices of the Council of Financial Regulators. That is actually quite a difficult issue for Australia because, without wanting to go into great detail, there is the issue of whether we ought to mandate central clearing of certain instruments onshore so that they do not drift offshore—or not. It is quite important, and there is a consultation paper out at the moment on that matter and the council has to form a judgment on that.

So those things are all being done. Is there more that we should be doing? I think that the fundamentals ultimately matter most. We want good prudential supervision, and I think it is very important that the government fully and properly resource APRA to do that. We also want effective oversight of various markets, and ASIC comes in at that point. We want overall financial stability, which we feel is our obligation even though it is a bit hard to define what stability means other than by you know it when it is not there. But all those things mattered greatly in the crisis, and were there to be another crisis they would matter again. I would say that in a number of respects we are probably better placed now than we were three years ago. If we take the reliance of banks on offshore wholesale funding, they still have some but it is much reduced. In fact, they could probably cope with the closure of those markets for a period of time—that has not happened, but if it did.

Banks are pretty well capitalised. The consumer balance sheets, as I said earlier, are coming into better shape too. There is a number of ways in which, while we do not want to say that nothing would bother us, I think that perhaps we have a stronger position than we had a few years back.

Ms O’DWYER: That is an interesting perspective. You have talked about governance, so I might as well go to those questions now. I know that in previous testimony my colleague Steven Ciobo asked some questions regarding Securency and Note Printing Australia over the last two hearings. You have provided testimony to this committee that the first time that the RBA became aware of bribery allegations in relation to the agents of Securency was around May 2009. Is that a fair—

Mr Stevens: That is what I said and that is correct, yes.

Ms O’DWYER: At the time that they were made public in the media—in the article in the Age that was related to it—I understand that was the point when you involved the police?

Mr Stevens: Correct.

Ms O’DWYER: I am just trying to understand; if there were allegations regarding Note Printing Australia, which was a sister subsidiary to Securency, and those allegations were made in May 2007, is it correct to say that there was a board paper presented to the board in relation to Note Printing Australia at that time?

Mr Stevens: To the RBA board?

Ms O’DWYER: Yes.

Mr Stevens: Do you recall, Ric? There was a board paper at the NPA board in early 2007 that reviewed, as I understand it, the implementation of stronger policies surrounding agents that they had adopted in the preceding year. The board had a process of quizzing the management, ‘How are we going with this?’ and giving them a bit of a hurry along, I think. Is that correct?

Mr Battellino: Yes. The background here is that, after the Cole royal commission, like many organisations the Reserve Bank board said: ‘Well, you’ve got these subsidiaries that are using agents. What do we know about the policies that govern that use of agents?’ They asked questions of the NPA board on those policies. Remember
that NPA is a separate organisation from the Reserve Bank and the responsibility for managing NPA rests purely with the NPA board. So they asked the NPA board and the NPA board in turn set in train a process of reviewing the policies and strengthening the policies. That process was completed in around July, I think, 2006. By that stage the company had a new set of policies and the question was implementing those policies. By early 2007, the board of NPA were becoming frustrated that management had not implemented the policies yet, so they were pushing management to do it. They asked management for a status report of where things were up to, and that was discussed at the NPA board meeting in May that year.

Ms O'DWYER: So nothing was sent to the RBA board at that point?

Mr Battellino: No.

Ms O'DWYER: There was no information provided?

Mr Battellino: No. The RBA board, having asked the questions about the policies, were given the policies in the middle of 2006, and basically they accepted those policies as being sound policies. The problem was the implementation. So, as a result of that meeting in May, the board of NPA said that there were issues about bad business practices in relation to the agents and things like that, so they took some fairly hard decisions. They said, 'Look, we want to stop the use of agents.'

Ms O'DWYER: Didn't the NPA sack all of the agents at that point?

Mr Battellino: Yes, they stopped the use of agents. At the same time they commissioned an audit of what had been going on with the use of agents. That audit started more or less immediately. The audit was completed around early June 2007. The audit made a number of recommendations, which basically said, 'Stop using agents,' and said that the NPA board should undertake an investigation to make sure that no Australian laws had been breached.

Ms O'DWYER: Just so I am clear on this point: even though NPA—which is, as I understand it, a 100 per cent subsidiary of the RBA—had sacked all of its agents, that was not made known to the RBA board?

Mr Battellino: Yes, it was.

Ms O'DWYER: It was. At that point, did the board ask questions?

Mr Battellino: Yes. The main problem with the agents was that there were very—I would say—not sound business practices around the way those agents were being controlled. This goes back. The board of NPA had been disappointed with the management of NPA in a number of respects in terms of business controls relating to security and a number of issues like that, so there had been a sort of ongoing disappointment there with the management. This all came to a head in the middle of 2007, where I think the board of NPA said, 'Look, we don't think it's worth continuing with this model,' and they stopped the use of agents. The business was refocused onto mainly supplying Australian banknotes and continuing to look after any existing overseas customers, because there are quite a number of customers now who use NPA to print their money. The whole business was restructured then. In terms of that investigation, the board had to commission Freehills to do that—

Ms O'DWYER: I have two follow-up questions in relation to what you have just mentioned. The first is: why, after sacking the agents—obviously there was serious concern to sack agents—were the police not contacted at that point?

Mr Battellino: There was no basis to. This was an investigation that was started by the NPA board as part of an ongoing control around the way the business was being run. They pursued that to its logical conclusion. You would have to accept that it is a very serious matter for any organisation to call in the police to have its staff investigated. My guess is that most organisations would not do that without—

Ms O'DWYER: It is very serious to sack them as well, isn't it?

Mr Battellino: To sack the agents?

Ms O'DWYER: Yes.

Mr Battellino: It is very serious, but that is something that companies do. They do terminate contracts. I think the board asked all the right questions, sought all the professional advice it could and acted on that advice.
Ms O'DWYER: My final question on this is: if there was a restructure, obviously the business model there was flawed given that Securency operated under the same business model and shared the same chairman, so why was that not also restructured immediately?

Mr Battellino: That is a good question. When we had the audit done of NPA, the question arose because we knew that Securency was also using agents. So an audit was done of Securency's use of agents as well. That showed a very different picture. That audit came back as a very sound audit with very few findings. In fact the conclusion—I forget the exact words—basically said the company had very sound business practices and policies. On that basis there was really no basis to discontinue the use of agents there. Remember that the RBA does not control Securency. For a decision to be taken to stop the use of agents, it would require the unanimous decision of the board, of which the RBA only had half. So there was really no basis for the board of Securency to stop the use of agents.

Ms O'DWYER: Weren't there some shared agents with Note Printing Australia?

Mr Battellino: At that stage, the agents that had been causing concern had been terminated at Securency as well.

Ms O'DWYER: They were terminated at the same time from Note Printing Australia and Securency?

Mr Battellino: Yes, within weeks. It was not simultaneous, but it was within weeks.

Mr BANDT: I would like to continue with some questions about Securency and NPA and what the members of the Reserve Bank board knew at what stage. Was there a meeting of the board of NPA in May 2007?

Mr Battellino: Yes.

Mr BANDT: On the board of NPA were members of the Reserve Bank board at the time?

Mr Battellino: No members of the Reserve Bank board.

Mr BANDT: Wasn't the chair of NPA Graeme Thompson?

Mr Battellino: That is right.

Mr BANDT: He was not on the Reserve Bank board at the time?

Mr Battellino: No. Graeme Thompson at that point had nothing to do with the Reserve Bank.

Mr BANDT: So there was no overlap between the boards of NPA, Securency and the RBA?

Mr Battellino: Let me give you list of people on the board. The board of NPA at that time was: Thompson as chair, Dick Warburton, Mark Bethwaite, Les Austin and Frank Campbell.

Mr BANDT: And of Securency?

Mr Battellino: The board of Securency was: Graeme Thompson, Les Austin and the managing director of NPA, which was Ogilvy.

Mr BANDT: Who was on the board of the RBA at the time?

Mr Stevens: None of those people were.

Mr BANDT: So there was overlap between the boards of NPA and Securency?

Mr Battellino: Yes.

Mr BANDT: They also shared an agent at that time, Mr Abdul Kayum?

Mr Battellino: Yes.

Mr BANDT: Mr Kayum is currently on trial?

Mr Battellino: Yes.

Mr BANDT: The NPA, at its May meeting, received a report?

Mr Battellino: That is right.

Mr BANDT: It has been suggested in the Age newspaper, since the last meeting of this committee, that that report said that at least one agent had admitted to bribery, at least one agent had demanded 'under the table' secret commissions, at least one agent had demanded excessive payments and that payments were being made to third-party accounts. Is that an accurate summary of what was in that report?

Mr Battellino: I cannot recall. A range of issues were raised in there. Allegations had been made by one of the staff members that the agents had said certain things. The agents denied those. One of the agents had sought to mislead one of the central banks overseas about the exact size of his agency fee. There were a number of issues like that.
Mr BANDT: After receiving that report, did Note Printing Australia call the police?

Mr Battellino: No.

Mr BANDT: Were any members of the Reserve Bank board at the time made aware of either the details or the essence of that report?

Mr Battellino: I go back to the situation I discussed in response to Ms O'Dwyer's comments. As I said, the NPA board had started its investigations. That investigation was about poor business practices. There were a number of allegations about various agents. But the basis of the decisions taken by the NPA board in May 2007, as I understand it, was really dissatisfaction about the whole way in which the model was being run. They just decided to change the model.

Mr BANDT: The Age newspaper summarises it and it puts it at a higher level and suggests that there might have been in that report, prima facie, evidence of illegal conduct by an agent of a subsidiary. If that were right, do you think they should have called the police?

Mr Battellino: This is where the audit recommended that the situation be investigated by the NPA board. That is what the NPA did. They hired a very sound legal firm to carry out that investigation. That firm concluded, having investigated everything, that there was no evidence of any breach of Australian law.

Mr BANDT: Was that reported back to the RBA board at any stage?

Mr Battellino: Yes.

Mr BANDT: When was it reported back?

Mr Battellino: That would have been reported back to the RBA board, I think, in early July, at the July 2007 meeting. The board were briefed on the results of the audit and they were told that an investigation had commenced. At the next meeting they were briefed on the results of the investigation.

Mr BANDT: When was the next meeting after the July meeting?

Mr Battellino: August.

Mr BANDT: So, by August, the RBA board had been given the Freehills's report and the RBA audit report?

Mr Battellino: The RBA board were briefed on the outcomes of both those. As far as I am aware, they were not given copies of those reports.

Mr BANDT: At some point while all this was happening Note Printing Australia sacked its agents?

Mr Battellino: That is right.

Mr BANDT: That included the agent who was common to both NPA and Securency?

Mr Battellino: Yes.

Mr BANDT: Given that, did the RBA board ask whether Securency had also sacked that agent?

Mr Battellino: I cannot recall, but basically they would have been told that an audit was also being undertaken of Securency's use of agents.

Mr BANDT: During 2007, did Securency take any actions to change its practices?

Mr Battellino: No, because, as I say, the audit showed that Securency had very good policies. In fact, even when we had KPMG come in and do a very forensic audit of the company which lasted for six months—it was very intensive—after the allegations were raised in 2009, they reached a similar conclusion: that the policies of the company were very sound.

Mr BANDT: Were KPMG given the RBA audit or the Freehills report?

Mr Battellino: KPMG had all the information that was available.

Mr BANDT: Including those two documents?

Mr Battellino: Yes.

Mr BANDT: That was 2009. Coming back to 2007, though, when the RBA board knew that there was at least one agent common to both of the subsidiaries and that one of the subsidiaries had sacked all its agents—but the RBA board presumably knew that the other one, as I understand it, had not made any changes—did you ask Securency or make inquiries of Securency during the course of 2007 or 2008 or before the allegations were made in the Age newspaper? Did you ask any questions about Securency's ongoing use of this agent?

Mr Battellino: I do not think the RBA board knew that there were some agents in common. I do not think that would have been an issue that they would have been across. That was a matter for the companies.

Mr BANDT: Wouldn't the audit have shown that?
Mr Battellino: As I say, the audit reports did not go to the RBA board.

Mr BANDT: Moving ahead to 2009, after the reports in the paper, you said the RBA board commissioned KPMG.

Mr Battellino: Yes.

Mr Stevens: The Securency board commissioned KPMG, as they should.

Mr BANDT: At what stage did Securency make any changes to its agency network following the revelations in the media in 2009?

Mr Battellino: It was around late 2009. At that point the KPMG audit investigation was still continuing, but they brought to the attention of the Securency board some information which they felt showed that the management had not been honest with the board and had been withholding information from the board. At that point the board of Securency terminated or suspended the management and suspended the use of agents.

Mr BANDT: Are those reports—the RBA audit and the Freehills report—public documents?

Mr Battellino: No.

Mr BANDT: Does the RBA have any intention of making those documents public?

Mr Battellino: All that information has been given to the police. The police have had those for a long time. They have been through it. These are matters before the courts, and I think that is the proper thing to have done.

Mr BANDT: When were those documents given to the police?

Mr Stevens: When they asked for them.

Mr Battellino: As soon as they asked. They were told of their existence as soon as the allegations about Securency were raised in early 2009, and as soon as the police asked for those documents they were given them. The police themselves have said on a number of occasions how the Reserve Bank and the two companies have cooperated fully with this investigation. There has never been any hint that the companies or the Reserve Bank have withheld any information from the police.

Mr BANDT: Were any of the people who were board members of Securency or NPA at any time, either before or after, also board members of the RBA?

Mr Battellino: Yes. Dick Warburton was a member of the RBA board.

Mr BANDT: When was that?

Mr Stevens: He retired from the Reserve Bank board long before these events.

Mr Battellino: Could I just add to that that Graeme Thompson at one point, when he was Deputy Governor of the Reserve Bank, would have been a member of the RBA board, as well.

Mr BANDT: Looking back on it now, knowing that there was such a high degree of overlap between Note Printing and Securency, including the use of a common agent and a common chair of both boards, and that the RBA fully owned one and half-owned the other, do you think it was appropriate that from 2007, whilst one company sacked its agents, the other one continued on with business as usual for a period of years?

Mr Stevens: You have got to look at what information was available to the two boards. In one case you had the Freehills work, who said that there are serious problems with business practices here but no illegality, so that board fixed that problem. And, as Ric said, there were many issues in NPA at that time that had nothing to do with foreign agents but were to do with their conduct and their performance as a printer for us. This was in a context of a wide-ranging refocusing of that company.

As you say, it is true that the other board had a common chairman. They also had the same group of auditors who had been to NPA go to Securency looking for the same issues and they came back with a completely different story. As Ric said, we know now certain information that should have been available to that audit and indeed to the Securency board was not available. Possibly that audit would have found a different conclusion had they had that, but they did not. So that audit came back with that finding.

I think the two boards acted reasonably on the information they had and the advice they received. That is really the story of why the agents finished in 2007 in NPA but, in the other case, not until more information became available.

I think there was only one common agent, wasn't there?

Mr Battellino: The Malaysian one, I think. Yes.
Mr Stevens: Actually, that was contrary to NPA's policies. That was actually a problem and that was part of the background to him being removed. There is the sequence of processes that generated information, the response to that, the getting of advice—the advice had two bits in NPA: 'There is a problem here. There is not illegality here.' So they fixed this problem.

Then, with Securency, of course the same auditors go and the Reserve Bank actually pressed for that to occur. Obviously, the answer was completely different. I do not think the board of Securency at that time had a logical basis on which to say, 'Right, we are going to sack all the agents.' Information changed later, of course.

CHAIR: Thank you for your openness on that.

Mr STEPHEN JONES: Earlier you were asked about Dutch disease. I come from a region in the Illawarra that includes BlueScope, one of its largest employers. This week 1,000 workers from that plant were advised they no longer had a job. That adds to similar announcements by OneSteel and other manufacturers of job losses in the thousands. I do not really need to contemplate too much about whether regions like mine have the Dutch disease. We have seen the hollowing out of manufacturing at a pace we have not seen before. The question I have for each or any of you is: in its monetary policy setting, what consideration is the RBA giving on the impact of monetary policy on regional economies like mine and on industries such as manufacturing?

I say that noting some of the comments from the August board meeting and the comments that you made today.

Mr Stevens: I am not sure that you will find my answer terribly satisfying but I think these issues of structural adjustment—that is a mealy mouthed term isn't it—are difficult. Some parts of the economy will shrink while others grow. I wish I could say that we had a way of avoiding that. I do not think we do. I do not think monetary policy can stop that occurring. I think what we have to do is try to gauge the overall amount of spare capacity in the economy in total and that is very important in our assessment of the stance of policy and work from there. We are certainly conscious that the exchange rate in this episode is giving more of the tightening than it has done in some other episodes. I believe we have done our very best to account for those impacts on the overall economy. We do not have an instrument that can prevent these shifts in the structure of the economy from occurring. I am sorry but I think that is just the reality.

Mr STEPHEN JONES: The issue of the exchange rates has been a matter of some discussion over recent weeks. I invite you to comment on it. In the August statement on monetary policy you had usefully included at page 29 a table which charts the movements in the US dollar against selected currencies. I note in the same table that the Chinese currency has only appreciated by five per cent over that period. That seems to be out of step with all known reality when you look at the growth rate of the Chinese economy and the capital flows. What should policymakers be doing here in Australia about what seems to be a lack of credibility in the setting of the Chinese currency and the impact that that is having for businesses here in Australia?

Mr Stevens: That is a good question. It is a question being asked around the world. In my opinion on any objective gauge the Chinese currency should be higher today than it is. They are still doing quite a bit of intervention. It is coming up some. I think it would be beneficial to the global economy and indeed beneficial to the Chinese people for there to be more flexibility in that price. There is no shortage of people telling the Chinese authorities that and in private discussions that we have that issue gets raised. Unfortunately, it gets surrounded by the whole US China relationship issue. The megaphones come out, there is a bit of shouting to and fro and actually that is not all that productive. It is a significant distortion in the global system and it is actually giving rise to, I think, another significant imbalance which is that China—and, indeed, Asia generally—have very large quantities of official foreign assets and they are overweight in dollars. This is an imbalance that will be a problem for the global economy in the years ahead. What can we do about it? We can make the comments I have just made, and no doubt they will be publicly reported, but what would really make the difference is a long-run engagement with the Chinese side on why it is actually in their interests to be more flexible. That is a government decision. My assessment is that the central bank there would do more on this immediately if it were their call, but it is not: exchange rate regimes are a government decision. I think that is what we can do, but that of course promises no early solution to what is continuing to be a growing structural problem in the global economy. With all my colleagues around the world this is a very common topic of discussion, but to date it has proven difficult to make a lot of progress.

Mr STEPHEN JONES: These are not disassociated questions. If we are seeing a very rapid economic restructuring occurring here in Australia, at least in part because of an artificial advantage that one country gains
through the suppression of its currency, it poses real questions for domestic policy makers about what we do in response to that. It is an issue of immediate concern, I must say, for me and for the electorate I represent.

Mr Stevens: I can understand that. But what can we do about it? Arguably, interest rates can be a bit lower than otherwise and I would say they are. We have not done intervention in the currency in this recent period. I thought that at $1.10 it was getting a bit ahead of itself, but it has fallen back a bit since then. We have not done intervention because our assessment is that it would be fairly futile in the environment we are facing. There are very big forces at work globally.

Mr STEPHEN JONES: Changing track for a moment, in response to some questions you were asked earlier about productivity in general—the focus was on labour productivity. You made some anecdotal observations that seemed to me to be out of step with the limited evidence in this area about labour productivity and flexibility. I accept that they were anecdotal observations, but when it comes to flexibility we know that, at least in relation to hours of work, the Australian workforce has shown enormous flexibility over the last decade and that there is no credible evidence to suggest that industrial instruments over successive periods of industrial regulation have been an inhibition on flexibility around hours at work. We are working more hours in Australia and than just about any other country in the OECD at a time when industrial instruments largely regulate we work 38 hours per week.

Mr Stevens: I was asked about what people had said to me. I think that was the question that came, and that is what a number of people have said to me. I would be the first to say that I do not have a rigorous study which can quantify whether that is material or not. I am relaying what a number of people have said.

Mr STEPHEN JONES: On the productivity question, I believe insufficient attention is given, perhaps even in relation to our monetary policy, to capital accumulation and investment in plant and equipment. You read through the Productivity Commission's list of obstacles to productivity growth in this country, and certainly in the sectors that I have cited, where I believe there are significant issues in manufacturing in particular, it is the rate of capital accumulation, investment in plant and equipment and technology, which is the biggest brake on productivity growth, not labour factors. And monetary policy does have a direct impact, a direct bearing, in that area.

Mr Stevens: Actually, on the available figures, the country's capital stock—the stock of equipment, structures and so on—has been rising quite quickly over recent years. Indeed, when people compute the multifactor productivity they are taking into account the amount of capital as well as the hours of labour. I suppose the arithmetic is showing that apparently there has been a substantial rise in the capital stock, with—as yet, at least—marginal output growth coming from that, not at the same pace that it once might have been. Perhaps that is a temporary thing, at least in some areas, but I do not actually think it is true that there has not been much investment. I think in fact there is quite a bit going on. That is what the figures show.

Mr STEPHEN JONES: Shifting again, I want to briefly ask for your observation in the area of housing. It is impressed upon me, certainly in some of the regional areas that I speak to and in capital cities, in the suburbs around Sydney, that there is a shortage of housing and a lack of new housing starts. I am wondering whether this is a matter that the RBA is taking into consideration in its monetary policy and whether you believe that the current lack of activity in the sector is going to lead to another unhealthy asset price bubble in three to four years time.

Mr Stevens: I think that this question of—as best one can tell—not enough addition to the dwelling stock for population, even though population has slowed down, and why that is, is a very important question. I do not have a kind of easy answer to it, but I think there is still in the banks a certain tightness of availability of credit. I think that is tending to ease a little bit, but there is a long way to go there yet. The rental returns on the rental stock I suspect have actually been lower than really needed, because people were getting part of their return through capital gain, so the rental yield can be low, but I do not think we can keep having indefinite capital gain. To get the return, you actually need the rental yield to offer the investor a return, and that is coming up gradually.

I am sure I have said this before; I am not an expert in these matters. How is it that a country of our size—we are not short of land—cannot add to the dwelling stock for the marginal new entrant more cheaply than we seem
to be able to do? I cannot get past that basic question. But—without denying that interest rates have an effect on the housing market, obviously—it seems to me that this goes to a whole group of things on supply, zoning, transportation, infrastructure et cetera. I think Phil would probably say, without putting too many words in his mouth, that better transportation could in a sense increase the amount of well-located land—that is, land you can live on and from where you can get to and from your job quickly.

I think these are very important questions. I do not consider myself an expert in them and I had better stop offering too much opinion here lest I say something wrong. But they are very important and they have a very important social dimension. There is a very big inequality between generations that is building up. I think that is a social problem as much as an economic one.

Mr Stephen Jones: A concern, Governor, is that decisions that are not being made now are going to have an impact in three to four years time, exactly as you have identified.

Mr Buchholz: I have an inflation question. Headline inflation is outside our range and underlying inflation is towards the top end of it. If I could just draw your comments back to something that you said during one of your answers about the limited impact of the mining sector on inflation and get you to expand on that. What inflationary pressures does the mining sector have on the economy at the moment?

Mr Stevens: Let me see if I can articulate. The shock to the mining sector is expansionary for the economy. Incomes rise. They demand more inputs—goods and services and so on. That adds to it. The investment build-up also adds. So in general demand increases and the economy has to supply at least some of that demand. My point earlier was that I do not think you can pull apart the CPI and say, 'There are a couple of bits here that are just mining and that is all there is.' I do not think that is the case. One of the channels people do worry about is: will the tug of labour into the resource sector push up aggregate wages? I do not think it is doing that at this point. Our discussions with business do not point to widespread difficulty in attracting labour the way they did in 2008. At the moment I do not think that is proving to be a problem, but of course the mineral boom has a way to go yet.

To come back to Phil's point from earlier, productivity data are difficult to measure and you have to be careful using them and so on, but as best one can see the unit costs have been rising pretty smartly over the past five years or so, much of the time. They dipped very deeply during the international crisis. Productivity has been weaker and costs are coming and they are fairly widespread. They are not directly mechanically attributable to the resource boom. The resource boom, all other things being equal, does add to income and demand in the economy compared with the alternative situation. Then you have got things that work against that. The exchange rate goes up, which leans into the expansionary impetus. These things automatically occur and the ultimate question is: what is ultimately the net effect?

Mr Buchholz: What about being more specific within the mining sector—the one in 100 year capital expenditure line item of the industry?

Mr Stevens: It is very large. Typically, resource sector investment was running at between one and two per cent of GDP. It will be six per cent, we think, at the peak in another year or two. That is a very big change. Some other sectors have softened a bit, but overall investment in the economy in the business world is pretty solid. What impact does that have? There is a debate at the moment about how much of that gets supplied from onshore versus imported. Certainly there is a significant import component. When we import things that does not create inflation for us; that is alleviating inflation. But there will be a reasonale spin-off of these things around the rest of the economy, I think, and that is part of our general outlook. If what we have written down turns out to be right—and they are only forecasts, and forecasts are not very good; no-one's are—what they say is that growth will be at trend, not now but out into the future, and there will be a bit of pressure on overall inflation. That is the forecast we wrote down in early August. As I said earlier, one of the issues is the extent to which the events that have been occurring in recent weeks dampen demand pressures over time. We cannot know yet, but that is one of the things we have to keep an eye on.

Mr Buchholz: You say that you take the opportunity to look through certain situations—the cyclones. What do you determine? What are the points that help you determine whether or not you are going to look through a particular situation?

Mr Stevens: It is whether it is a one-time identifiable thing which, in that case, will actually reverse within a matter of months. So it would be pointless, really—

Mr Buchholz: Wouldn't the construction phase in the resources sector follow the same graphic or trajectory?

Mr Stevens: Not within a matter of months; it is going to run for years, and that is the point.
Mr BUCHHOLZ: I come from an electorate where, in the Grantham and Murphys Creek area, we will be cleaning up for years.

Mr Stevens: Which actually adds to demand, in fact. Unemployment up in that region is pretty low, isn't it?

Mr BUCHHOLZ: Yes. Now that we are talking about my electorate—I do not know how we got there, but it never seems to elude this question time—my electorate does not have any linkages into the resource sector, so I am in that 75 per cent of Australians that are hitting that one per cent growth rate. What do you suggest I say to my businesses, particularly in the retail sector, that are telling me that this is the worst environment that they have had to trade in? Some of those businesses are generational.

Mr Stevens: I cannot give you easy solutions to those questions. My point, I think, would be that we went through earlier what the spillovers around the community are from the resource story. They are there. People cannot see them directly. That is quite understandable, because some of them are quite opaque, but they are there. In the end, if the unemployment rate in the electorate is, as I think it is, three or four per cent, that is not so bad, is it? Ultimately the question is whether we have most people in a job at a sustainable inflation rate. That is what we are seeking to achieve.

Mr BUCHHOLZ: On the periphery of my electorate, on the Gold Coast, I have huge issues on retail, construction and tourism, and none of those rates that you mentioned earlier on fall anywhere within the national average.

Mr Stevens: Absolutely. South-East Queensland has significant issues. They are partly exchange rate issues; that is absolutely so. They are also, I think, the outworking of the earlier period of property booms and busts; I think that is quite a big feature. I think that, in the story of some of the lower lending standards and so on, it is like western Sydney was a few years back; it is also like some areas of Perth are. That is a function of a period of very great optimism, rising property values and rising debt which then, as we know, usually gives way to things turning down for a while. I sympathise with that. I have a number of regular correspondents from the Gold Coast. Mr Ciobo is not one of them; he is rather more polite. So I am aware of that. As I say, I think some of these things are to do with these other forces in the financial cycle. The talk I gave in Brisbane some months back tried to grapple with that.

Mr BUCHHOLZ: What comfort can I give to my mums and dads? Your data shows that they have got increased household savings. However, when you quantify that and turn it into a material thing, they are probably a couple of payments ahead on their mortgage but that is little comfort to them when the reality of the market they live in means that they have probably torn up about 30 grand in the value of their property from the downward trajectory of real estate values.

Mr Stevens: I do not know how prices in that particular area per se have moved. In South-East Queensland they have declined; across the country it is variable, though most prices remain a good deal higher than four or five years ago. Actually I would say that the majority of people in the country are ahead on their mortgage. That is a fairly standard fact and some of the major banks quote 60-odd per cent of people have made advance payments. So the stock of savings is rising as a result of that.

You mentioned the mums and dads. Well, the grandmums and dads want us to preserve the value of their savings, don't they?

Mr BUCHHOLZ: I don't deal with them just yet!

Mr Stevens: Well, they're there.

Mr BUCHHOLZ: I'm more to do with the mortgage punters.

Mr Stevens: Exactly, and fair enough. But 35 per cent of people in the country have a mortgage; 65 per cent do not, of which slightly more than half have paid off, and the other half rent and they would like to have a mortgage if the prices of houses were a bit lower. There are varying groups here. With all compassion towards people with a mortgage, there are also people with savings and people who would like to have a mortgage.

Mr CIOBO: Can I change the topic to an old hobbyhorse of mine, and it is not Securency. It is the issue of three-party and four-party schemes and interchange rates. In your capacity as a regulator, can you outline for the committee, given that some time has now elapsed since regulatory changes were made, what has happened in terms of market share between the three- and the four-party schemes?

Mr Stevens: I think in recent times the three-party schemes have gained some market share. A lot of that comes from linking up with some of the banks to issue cards. I think that is probably what is going on there.

Mr CIOBO: Some of the concerns that I and others raised at the outset of this was that we would see an erosion of competitiveness by the four-party schemes over the three-party schemes because of, I would suggest,
the regulatory imbalance that arose as a consequence of the intervention. If that is the case, and as I understand this matter will be reviewed again next year, are you able to provide the committee with any insight on your thoughts on the matter?

**Mr Stevens:** It would probably be a bit premature to do so. The Payments System Board certainly is conscious of the comparison and the four-party schemes continually make the point that the three-party ones are not subject to the same intensity of regulation, though I think those schemes have actually voluntarily complied with certain things that the board wanted.

I think this ought to be part of a wholesale, ongoing discussion about not only interchange regulation but also surcharging, where, as you know, we have got a review going on at present. Most of the submissions on that have taken the positions that you would expect, given who wrote in. So we will have to come to a position on those matters. That actually does, I think, go to the three versus four party because of the practice of blended surcharging that the three-party schemes tend to try to promote with some of the merchants because it is to their advantage to do so. So those things are under review at the moment.

**Mr CIOBO:** Given we have seen a shift in market share between the three- and four-party schemes, with the benefit of hindsight do you think it was a mistake to have only regulated part of the market?

**Mr Stevens:** I am not sure I would draw that conclusion. There are not interchange fees in the three-party scheme, so if you are regulating interchange fees there is not one to regulate there. The question, I suppose, ultimately in the end is—

**Mr CIOBO:** It might not have that name but it is a similar mechanism.

**Mr Stevens:** I am not sure I should concede it was a mistake. Phil probably knows a lot more about this than I from his previous role, but the board's attitude is that if unintended consequences occur that we can address then we will certainly seek to do so. I am very conscious that I do not want to see the Reserve Bank go down into the role of regulating more and more here. I think that is strategically not the right direction. I think a few simple things that we can hold to for long periods are probably best. Did you want add anything, Phil?

**Dr Lowe:** Yes. It is a broader comment, really, but a lot of this reform was about the relative incentives for people to use credit cards and debit cards. We have seen very big changes there, partly due I think to the consumer caution that we have talked about—that people do not want to use credit as much as they did before and they are happy to use their debit cards. The relative price of using credit or debit cards has changed as well as a result of those reforms. We no longer get charged when we use a debit card. Some of us used to get charged. The points that we get from using credit cards have declined as well, so there has been a narrowing of the relative price differences.

**Mr CIOBO:** That may be right but the four-party schemes were not necessarily—

**Dr Lowe:** They have come down as well. The average charge that the three-party schemes are levying on the merchants has come down, partly because of the surcharging and partly because of the competitive pressures in the system. The rewards that we get from using credit cards have diminished and the cost we pay for using debit cards has gone away. So I think people have partly responded to that and as a result there is more use of debit cards and less of credit cards. That was not an objective of the reform; it was really to get the price signals together so that people would make choices based on underlying costs of providing these things rather than distortions coming out of the interchange system. I think that, broadly speaking, that has worked.

**Mr CIOBO:** I am mindful, Governor, of what you said, and I agree that more regulation is not necessarily the outcome to achieve, for lack of a better term, competitive neutrality. There is the other alternative, which is to take a step back. Are you willing to provide any insight into what your preferred method between those two options would be if competitive neutrality were a guiding factor?

**Mr Stevens:** I have given a fair bit of thought in the time I have been in this role as to whether it is possible for us to take a step back on interchange and about the condition that we would need to see in order to do that—and nothing would please me more, in a way, to be honest, because this is incredibly complex stuff and, as I said, I do not want to see us getting into finer and finer levels of regulation. What would we need to see if we were to do that? I think we would need to see some sense that competition within the system, generally speaking, has increased because the payment system board's mandate is efficiency but also competition. If we do not see any competition, that is really how we got into the regulation in the first place. If one could see clear evidence that we have competition between card schemes and between competing payment mechanisms or both, that is at least a precondition about which you could think 'maybe we need to do less intrusive regulation in the future'. Do we see that yet? I am not sure that we see quite enough. We have seen some encouraging things, one of which in my opinion is the development of EFTPOS—that becoming more of a network architecture with perhaps some
reforms to their governance and so on. Maybe, just maybe, that can be a serious competitor to scheme debit. And, if we had competition between systems, that I think is certainly a necessary condition that we need to see for us to be thinking we can take our hands off other things. I think if we took our hands off the interchange now the interchange fees would just go back up and we would be back to the situation that Phil has been talking about that we were trying to move away from. They were at least the original intentions of the reforms. So it is a work in progress in that sense. As I say, I think a key issue is: can we see convincing evidence of competition in the system between providers and between mechanisms?

CHAIR: I just have a couple of questions. You have already talked about influences on electricity prices here as a lack of investment over probably more than one decade, but in your opening statement in the fourth paragraph you also said that part of the slowing of growth in major countries is also likely to have been caused by the increase in energy prices. Is that a trend we have seen across the world?

Mr Stevens: I meant oil prices. Oil prices went up quite steeply in the first half of the year, and that typically, in countries like America or Europe, and even in Australia, acts kind of like a tax on consumers, so their discretionary income for other things is reduced. That is one of the things to which people appeal for the growth slowing in the major countries in the June quarter—not the only one.

CHAIR: If I were an ordinary person sitting in my lounge chair at the moment, I would be looking around the world and seeing what is happening in Europe and the US and I would remember the Japanese earthquake et cetera. I hear people sometimes say: if there were another major shock—not one of the shocks caused by strong things like growth of commodities et cetera but on the downside—would Australia be in a position to respond? I am well aware that there are many countries that would not be in a good position to respond, but how are we, relative to where we were before the last global financial crisis, in our capacity to respond?

Mr Stevens: I assume you mean, by macroeconomic policy, stimulus—

CHAIR: You have already said that banking is in a very good position.

Mr Stevens: Yes, banking is good. As I said earlier, I think we could even argue that we are in a better position there than before.

CHAIR: In monetary policy—

Mr Stevens: But in the late 2008 period, of course, we had had high rates of interest combating inflation. There was a lot of room to cut when the outlook changed a lot. Similarly, the budget was very strong. People want to quibble with this measure or that, but there was no question that you could undertake significant fiscal easing without impairing the long-run public finances of the country. If we did see a very dramatic change for the worse in the global economy, certainly the policy ammunition—we have plenty of interest rates to play with if need be, and I would still, I think, say that the fiscal position maybe does not look quite as good as it did then but, when you compare with other countries, it is in pretty sound condition. The issue for us would be: would we have some comfort that the inflation track is going to look better? We certainly did believe in late 2008: this is really going to turn it down and we should respond quite quickly. I would hope that we could be in that position again were there to be a dramatic event, but I am not quite as certain now as I might have been then. But hopefully we would have some leeway. So I think, in terms of macroeconomic ammunition, there would be not that many countries who can say they had more than us in the event of a really big episode. I do not think that is what is occurring at the moment. But the thrust of your question is, 'If it did, would we have some ammunition in the cannons?' and I think we would.

CHAIR: Thank you.

Mr Battellino: It is probably worth adding that there is plenty of scope for the exchange rate to take some of the adjustment, as well. Given its very high level at the moment, there would be a lot of room for the adjustment to come via the exchange rate.

Mr Stevens: And it would. That is absolutely right.

CHAIR: One last question and then we will hear from the school kids again. We have heard a little bit about Dutch disease, but it sounds to me that, when I read some of your statements, you see the changes that are taking place now—growth in Asia, obviously, the exchange rate, commodity prices et cetera—as things that, if not permanent, are certainly quite substantially long-term.

Mr Stevens: I think it is very likely that that part of the world economy will provide a lot of the growth impetus that is relevant to us. I think it is quite likely that the demand for natural resources will be strong for quite a while. I doubt, though, that the absolutely very high prices we presently see will persist. I think they will come down; indeed, we assume they will by a substantial margin. Whether we have got that exactly right I do not know.
The terms of trade will not stay this high, but I suspect that the fundamental shift in the structure of the global economy is quite a long-running thing. It is profound for everyone, including Australia.

**Ms O’DWYER:** I was interested in following up on the question of global inflation, on the point you made in your opening statement about the links between global inflation and monetary policy in Australia and also in combination with the exchange rate. Would you comment on the confluence of those three things?

**Mr Stevens:** A few things are at work here. Global monetary policy is quite easy, really. In major countries it is very easy. It is tightening in the emerging world, which may or may not have a bit more to do—I am not sure. But that very easy policy, particularly in the United States to the extent that other countries like China, but not only China, at least condition what they do off exchange rate considerations. That has tended to give them quite an easy stance over recent years. That is part of the story of the strong growth and rising inflation in the region. That does not make our life easier. It would be easier for all of us if there were more exchange rate flexibility in some of those countries, and, in a sense, for them not to contract out quite so much of their monetary management to the Fed. That would be better. It is a world I hope we see at some point, but it will be a while coming. In the meantime, there is the strength of demand in Asia and South America. Those are factors which are pushing up global commodity prices, including oil and so on—the bulk of commodities that Australia sells. Our exchange-rate shields the consumer from a fair bit of that. If we had a 70c dollar we would be paying a lot more for petrol and taking far fewer foreign trips as well. That is what the floating rate is supposed to do; it is supposed to help insulate you. In the textbook it insulates you fully, but in real life probably less than fully. I think it would be a better world if all the emerging countries had a flexible inflation target and a floating exchange rate, like us, and allowed their currencies to move as they should. We would then all be doing a better job collectively of controlling global inflation, and would have fewer imbalances in the world economy. That would be good. I am not exactly holding my breath.

**Dr LEIGH:** Governor, I want to come back to you very briefly on the issue of productivity and labour market deregulation and urge you to place evidence above anecdotes. I would make three points. Firstly, the turning point on productivity is around 2000. Productivity, if anything, declines more rapidly in the Work Choices period, 2006 to 2009. Your recent conference had papers on the labour market from Jeff Borland, who found that Work Choices had no impact on reducing unemployment, and on productivity from Saul Eastlake, who said, ‘In particular, the workplace relations reforms, introduced by the Howard government under the term Work Choices in its last term of office, were not primarily productivity enhancing.’ Should that not put the nail in the coffin of any claims that going back to Work Choices would boost productivity?

**Mr CIOBO:** What a ridiculous question.

**Mr Stevens:** I am not advocating any particular system here. I was asked a question, referring back to something I said in an earlier hearing, about anecdotes. I am always happy to try to find evidence and if the story is that, collectively, over a long period we have lessened the reform intensity and if that happened under successive governments, then so be it. But the point is, as I think Saul Eslake made pretty clear in his paper, in his usual inimitable and frank style, it has slowed. While I do not have a silver bullet policy to fix the problem, I can do no other than say as a public official that we should be giving careful consideration to these matters but, by all means, on as rigorous evidence as we can find. I am very pleased that the Reserve Bank conference provided some.

**Mr BANDT:** I forget exactly how you referred to the Productivity Commission before, but I think you said it is made up of ‘people who think about this stuff all the time’. A couple of months ago, the chair of the Productivity Commission said, ‘The key influence on Australia’s recent productivity slump has been the massive injection of labour and capital, together with more costly production and resource depletion effects, directed at satisfying minerals demand.’

The Australia Institute recently disaggregated mining productivity and non-mining productivity to suggest that, if you look at it that way, if you took 1995 as the base, in fact the non-mining sector has continued to grow, 40 per cent higher in 2010 than in 1995, but it is mining productivity that is in fact slumping.’ Do you agree with that analysis?

**Mr Stevens:** I think there is substance to the statement that there has been, as measured, a significant decline in mining productivity and that obviously must affect the aggregate. I can get Dr Lowe to elaborate but, on the work that we have seen—which is not our data; it is other official ABS data—

**Dr Love:** We looked at, I think, 16 different sectors where we can get the data. In 14 of those 16 sectors, productivity growth has declined since 2004. The declines in some of those industries are not very large, but it has declined across the board. Interestingly, in mining we had to use a lot of extra inputs, a lot of extra labour.
and capital to get relatively little output. The value of that output is very high because of the high global commodity prices. Ultimately, what matters is the real value of the output. So I do not think the decline in productivity in the mining sector is a bad thing.

Mr STEPHEN JONES: It could also be the production labour.

Dr Lowe: It could be the production labour but, if you look at the real value of extra production from the labour and capital, you will see that it is high because global commodity prices are high. I think productivity growth in mining will recover. It will recover in the utilities sector, because we have had to do a lot of investment to increase the reliability of the electricity distribution system. That ends up being reflected as lower productivity, but it is actually increasing reliability. I think that will turn around.

As the governor said before, even in manufacturing and a number of other sectors, the fact that there is a lot of investment in plant and machinery going on because the global price of plant and machinery is low because of the high exchange rate gives some optimism that you could see a lift in productivity increases again, after a decade when—at least in our analysis, and the same with Saul Eslake—the productivity growth slowed across a very wide range of industries.

CHAIR: Thank you. We will bring over the students again.

Callum Scott: I attend Eltham College. What impact are the inflationary pressures in China likely to have on monetary policy in Australia?

Mr Stevens: Callum, that is quite a good question. I think the Chinese economy is experiencing some inflation pressure. Ric may want to add to this. For some years China exported deflation, in a sense, to the global economy—more cheap stuff. Maybe we are seeing a transition to a world where they are exporting inflation. If that is true, that actually makes the job of central banks elsewhere more difficult. Do you want to add anything, Ric?

Mr Battellino: I only want to confirm that I think that is the case. We went through a period from the early part or the mid part of the 1990s through to about 2005 when China was adding to the supply of cheap manufactured goods around the world and really pushing down prices, so it was very favourable for everybody else. But now their living standard has risen to the next level, where they are demanding more and more goods and services themselves. They are now the biggest producers of motor vehicles in the world. They all want to drive. They all want to buy more petrol. This is now pushing up the cost of goods to everybody else in the world, so they have become a source of global inflation. I think that is right.

Francesco Carosella: I attend Trinity Grammar School. The current strength of the exchange rate is causing problems for some sectors of the economy, but would a fall in the exchange rate not cause greater problems for the general economy, as this would imply a high nominal interest rate is needed to meet the inflation target?

Mr Stevens: That is another good question. What the change in the exchange rate means for monetary policy always depends on why the change happened. If you go back, for example, to late 2008 and early 2009 the exchange rate went down a long way because the fundamentals of the global economy, and therefore of ours, changed so dramatically that we actually lowered interest rates. But there could be other times when the exchange rate falls for some other reason, which might have us thinking that needs to be offset by higher rates. In economist-speak it hinges on what the shock was which drove the exchange rate change. That is what you need to know in order to determine what bearing on monetary policy it would have. But you are right that, if there was a big fall on the exchange rate, that might well be because there were big problems around the world. That is an important point.

CHAIR: Thank you very much to the high school students who have attended today. Thank you, Governor, Dr Lowe and Mr Battellino.

Resolved (on motion by Mr Ciobo):

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

Committee adjourned at 12:34