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Members in attendance: Mr Buchholz, Mr Ciobo, Dr Leigh, Ms O'Dwyer, Ms Owens, Mr Tony Smith.

Terms of Reference for the Inquiry:
   To inquire into and report on:
   Reserve Bank of Australia annual report 2011
WITNESSES

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

Committee met at 9:30.

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 school students. Since the previous hearing in February, the cash rate has been reduced 75 basis points to 3.5 per cent. The RBA noted in its August statement on monetary policy that the outlook for the Australian economy is largely unchanged from the May statement. The stronger-than-expected growth in the first half of 2012 has boosted the forecast for GDP growth over 2012 to 3.5 per cent. The economy is then expected to grow at around three per cent over 2013 and 2014. However, the RBA noted that the economic and financial problems in the euro area remain the most significant downside risk to the forecasts for global economic growth. It should be noted that the fundamentals of the Australian economy remain robust, with low inflation and low unemployment, and there is a significant pipeline of business investment, particularly in the resources sector. In the domestic economy, there is ongoing public debate about the high level of the Australian dollar and the pressure this is placing on sectors such as manufacturing, tourism and education. The RBA, in its August statement, noted that it is possible that the persistently high level of the exchange rate may be more contractionary for the economy than historical relationships suggest.

During the hearing, the RBA will be scrutinised over its management of monetary policy and in particular whether the current level of the cash rate is providing the desired level of stimulus to the economy. In previous hearings the committee has scrutinised the RBA about the corruption allegations involving Note Printing Australia and Securency. I note that there have been recent media allegations about those events and the evidence given to this committee at past hearings. No doubt both the governor and the members of the committee will seek some clarification.

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. Governor Stevens, would you now make your opening statement before we proceed to questions?

Mr Stevens: Thank you, Madam Chair—and I am very pleased to hear that the school students will join us; I always look forward to their questions.

Since the meeting we had in February, assessments of the global and local economies have waxed and waned. In February, sentiment about the international financial system was recovering somewhat, after a scare late in 2011. The actions of the European Central Bank in extending its liquidity provision to euro area banks had taken major re-funding hurdles out of the picture for a time. This was a critically important action that bought time. It was clear that the European economy had slowed, that the United States was still growing—but at only a modest pace—and that China's growth was moderating to something more sustainable. But high-frequency indicators of the global business cycle were stabilising. So even though forecasts for global growth were at that stage being marked down a bit, we did not seem to be seeing a slump of the kind seen in late 2008. Subsequently, there were actually some small upward revisions to global growth forecasts.

But, as we said at the last hearing, sorting out the problems in the euro area is likely to be a long, slow process, with occasional setbacks and periodic bouts of heightened anxiety.

We saw one such one bout of anxiety in the middle of this year when financial markets displayed increasing nervousness about the finances of the Spanish banking system and the Spanish sovereign.

The general increase in risk aversion saw yields on bonds issued by some European sovereigns spike higher; while those for Germany, the US and the UK declined to record lows. This flight to safety also saw market yields on Australian government debt decline to the lowest levels since Federation. Meanwhile many European economies saw a further contraction of economic activity and share markets decline sharply.

Over the past couple of months, assessments of near-term global growth having gone up a bit between February and May have been marked back down. Bodies such as the IMF are forecasting world GDP growth of about 3½ per cent this year before picking up a little next year. These seem reasonable estimates at this stage, though the risks still seem weighted to the downside.
It is worth noting that we have still not seen thus far the sort of collapse in production and trade across a wide range of countries that was observed in 2008. The global slowing we have seen has so far at least been of the more ordinary variety. That is not to make light of these developments; only to keep them in some sort of perspective.

The kind of growth envisaged for the world as a whole is close to its long-run average. Of importance to Australia and as we noted in the February hearing, the Chinese economy looks like it has slowed to a pace of growth that is likely to be more sustainable. This is, though, clearly below the pace seen for much of the recent past, and the implications of this new pace of growth for the trajectory of demand for various commodities are still being worked through in the relevant markets.

Commodity prices have declined. Australia’s terms of trade peaked about a year ago, though they remain high in comparison with most of the past century. Overall, the developments in commodity prices do not seem out of line with what we can observe about the progress of the global economy.

Of late, financial market sentiment has again recovered somewhat. This is seen most clearly by share prices in most markets recovering the losses seen in midyear, while interest rates on peripheral European debt have fallen. It could not be said that confidence is strong. Uncertainty is high and much of this stems unavoidably from the situation in Europe. European policy makers have continued their efforts both to stabilise the immediate situation and to craft stronger pan-European structures for financial management so as to provide a more enduring stability. Their actions and commitments to future actions have been important but expectations for further progress are high. Realistically, it will be quite some time, I think, before the Europeans will be able to say that these problems have been put behind them, even if things go well.

Turning to the domestic economy, the sequence of changes in assessment has tended to be the obverse of what we have seen internationally. At the previous hearing, we believed on the basis of the available data that overall growth has been close to trend over 2011. Subsequently, we could not avoid revising that view downwards a bit as there seemed to be some emerging evidence that growth had been weaker than that.

The most recent data on the other hand are suggestive that the earlier assessment may in fact have not been too far off the mark. As recorded, domestic final demand rose by five per cent in real terms over the year to March, even with a small contraction in public spending. The strongest growth was by business investment in the resources sector but even consumption spending by households rose by about four per cent according to the national accounts.

A good deal of the growth in demand was supplied from abroad but nonetheless output is recorded as having expanded by a little over four per cent over the year to March. That result includes recovery from the flooding of the Queensland mines in the summer of 2011, so it overstates the underlying pace of growth. Even so, and allowing for a more moderate expansion of real GDP in the June quarter than in the March-quarter, which is what we expected, an assessment that economic activity has been growing close to trend over both the second half of 2011 and up to the middle of 2012 seems reasonable.

Consistent with this, the rate of unemployment remains essentially unchanged from this time last year.

Inflation at the same time has declined. The consumer price index rose by just 1.2 per cent over the past year. That is the lowest result for quite some years, though it partly reflects the unwinding of the large increase in some food prices that occurred in the first half of 2011, due to climatic events which had pushed up the CPI. Using the various measures we have for underlying inflation we would put it at about two per cent over the past year, which is still down a bit on the figure a year earlier.

The rise in the exchange rate, most of which occurred over 2009 and 2010, has had a significant impact on prices for traded goods and services. But this dampening effect on the rate of change of those prices now looks like it has started to wane. As it does, the more moderate growth of domestic costs and prices that we have seen will need to continue in order for inflation to remain consistent with the monetary policy objective. At present our forecast remains that this will be the case.

In May and June, as you said, Madam Chair, the board eased monetary policy, lowering the cash rate by a total of 75 basis points following the two adjustments made late last year. These decisions were based on the board’s assessment of economic conditions and the outlook with regard to the balance of risks. They have resulted in borrowing rates now being a little below their medium-term averages. Since then, with growth close to trend and inflation consistent with the target but the global outlook weaker than it was earlier in the year and confidence a bit on the subdued side, we have judged this to remain the appropriate stance.

It is too early to tell how much difference the sequence of decisions to lower interest rates late last year and in the middle of this year has made to the economy, though we can observe that dwelling prices may have stopped
their earlier gentle decline and business credit has in the past six months been growing at its fastest pace for three years. Consumption spending has been stronger over the first half of the year, but recent strength may in part be due to the effects of government compensation payments associated with the introduction of the carbon price. The exchange rate remains quite high, even with the decline in the terms of trade over the past year.

Looking back then, the economy appears to have been recording reasonable overall growth, relatively low unemployment and low inflation. Looking ahead, the peak of the resource investment boom as a share of GDP, the highest such peak in at least a century, will occur within the next year or two. After that the rate of resource investment is likely to decline while the export shipments of the resources themselves will pick up. By then we might expect that some other sectors that have been weak of late, like residential and non-residential construction, might be starting to pick up. Overall growth is forecast still to be close to trend, albeit with a different composition from that seen in the past year or two, and inflation consistent with the target.

That is the central forecast. It is conditional, of course, on a range of assumptions and there are as always risks and uncertainties, some of which we spell out in the statement that was published earlier in the month. At a time of significant global uncertainty and of important structural changes in the Australian economy the degree of confidence we can attach to particular forecasts is unavoidably reduced. We remain prepared to respond to significant deviations from that central outlook, to the extent that it is prudent and possible to do so, within a framework that aims to foster sustainable growth and inflation at two to three per cent over time.

That is what I want to say about the economy, but I feel it is important for me to make an additional statement anticipating, as you did in your opening remarks, Madam Chair, that the committee will be interested once again in the matters that we have been discussing for some time now—NPA and Securency which have been prominent in the media in recent days. Let me start by reiterating that the Reserve Bank condemns corrupt or questionable behaviour of any kind.

We have done a lot of work to tighten controls in the two companies. We have sought at all times to deal appropriately with all the issues that have arisen, and to cooperate with the legal authorities. We have sought also to respond honestly to questions from this committee. I and others have previously given evidence to the committee on the sequence of events as we saw them unfold. I think it is worthwhile to try to draw that together in one place and, in so doing, it is important to keep clear the distinction between the two companies in that sequence.

In 2006, following the events at the Australian Wheat Board, the Reserve Bank Board asked questions about the policies for the use of overseas agents by the two companies. In the case of NPA, the bank's questions prompted the company to begin a process of developing stronger policies. RBA management asked for an update on progress at NPA in early 2007, and the NPA board appropriately sought a paper from management on dealings with sales agents. After considering that paper, the NPA board decided that an audit should be undertaken of past practices and compliance. That audit raised several very concerning things. It recommended that, apart from discontinuing the use of agents, the NPA board undertake an urgent investigation into the role of relevant management and staff in dealing with agents to ensure compliance with Australian law. On receiving this report, the NPA board took the decision to cease the use of agents and, through a board subcommittee, commissioned Freehills to provide an assessment of the standards and compliance questions. It was while all these processes were under way that concerns held by a member of NPA's management over the company's conduct became known to an RBA assistant governor who sat on NPA's board. The NPA manager was asked by the then deputy governor to make a written statement. That document was part of the material examined by the Freehills team that was asked by the NPA board to examine the matters. We conveyed all those facts to the committee over the course of questioning at several previous hearings.

The document provided by the manager at NPA was held in strict confidence at his request. This was a condition required by him, and the bank agreed to it because it valued his willingness to come forward. Seeking professional legal expertise to assess the matters contained in this document, and the concerns raised in the audit, was a mark of how seriously they were taken.

The decision to seek an external legal review was an important one. In the bank's view, it was imperative to establish a process to investigate the issues thrown up by the audit findings and to ascertain and evaluate the facts regarding the NPA manager's concerns. This required an assessment by qualified experts on the legal questions. The bank believed that neither itself nor the NPA board should seek to make such an assessment. There are many precedents in the private and public sectors for organisations adopting similar processes in such circumstances. In the bank's view, this represented a proper, independent and rigorous process, and that was the intention.

The Freehills report was highly critical of NPA's practices, which were in need of major reform. It also concluded, based on the material then available, that there was no evidence of a breach of Australian law. That
assessment was provided in good faith and relied on in good faith. It was not proposed by Freehills or anyone else at that time that, having been through a process that concluded there was no evidence of a breach of the law, the next step should be to approach the police. When the Australian Federal Police were called in 2009 by the Chairman of Securcency regarding the allegations made about Securcency at that time, the 2007 NPA matters were all disclosed to the AFP in a timely way. The Freehills report and audit reports were provided to the AFP when requested. There was no attempt to hide any information.

It has been claimed by some that the written statement by the NPA manager contained clear evidence of corrupt behaviour. In 2007, two senior legal practitioners from a leading law firm who received this material directly from the author as part of their review, and who interviewed the author and others, did not view it that way in coming to their conclusion that there was no evidence of a breach of the law.

Even if it were ultimately to be concluded at some later time, with the benefit of hindsight, that the report reached an incorrect conclusion, it is completely without foundation to suggest that this process—that is, seeking information, conducting audits, having an independent legal review, implementing the recommendations from the review and the audits, and relying on the independent advice received—represented an attempt at a cover up by anyone in the Reserve Bank. There was no cover up. That is NPA.

I turn now to Securcency. The RBA Board asked Securcency for its policies on agents in 2006 and the company put in place additional and stronger policies and procedures. Following the audit at NPA in 2007, the Securcency board requested a similar audit and terminated one of its agents which it shared with NPA. That audit found that, unlike NPA, Securcency had ‘good and robust process’ in place in relation to overseas agent contracts and payments. A follow-up audit was conducted in 2008, which made the same finding.

It is for this reason that the Securcency board, and the Reserve Bank, had no reason at that time to discontinue the use of agents, as had occurred at NPA. With those audits having returned those findings, the Reserve Bank was completely surprised by the allegations that were published in the middle of 2009. We now know, including from a report conducted by KPMG for the Securcency board later in 2009, that critical information regarding the use of agents was withheld from the audit teams and the Securcency board in 2007 and 2008.

Finally, I turn to the question of the provision of materials to this committee. Currently, there are a number of court orders in place that place restrictions on the documents that the bank is permitted to disclose. The non-publication orders have been made as a result of applications not by us but by the individuals facing criminal charges and are designed to protect their right to a fair trial before an impartial jury. Further non-publication orders have been sought and obtained by the Department of Foreign Affairs and Trade and the Federal Police. Among the material subject to such orders is the statement of the NPA manager. I received legal advice in relation to whether I could table the statement. The advice was that I could not.

The Reserve Bank is, however, committed to transparency with this committee and with the community. To that end we are compiling a folder of the documents the bank has in relation to these matters, with the intention of tabling it for the committee at the earliest opportunity. These documents will include relevant excerpts from minutes of meetings of the Reserve Bank board, the NPA board and the Reserve Bank's audit committee in the 2006-2007 period, papers prepared for the NPA Board on the use of agents, the audit reports on the use of agents in NPA and Securcency, the statement by the NPA manager referred to above, along with associated documents, the terms of reference for the Freehills review, the Freehills review itself, and the report to the NPA board by its sub-committee that examined the issue. We are taking steps to seek the permission of the court to allow the bank to table those materials which are subject to orders.

To the extent that I can shed further light today, naturally subject to respecting the legal processes, I am of course more than willing to do so. That is a very long introduction, Madam Chair—thank you. My colleagues and I are here to respond to your questions.

CHAIR: Thank you, Governor, for your opening statement and for your candid response to the allegations that have been in the media in the recent days. I am sure that there will be some members who have some questions on that, but I think perhaps we will start with the economy—that affects the lives of Australians every day. In your statement you talked about some of the good news in the economy—there is no doubt that there is a lot of good news out there—but we often hear that the data is actually wrong, that the economy is actually weaker than the data suggests. It seems very common at the moment for people to say, ‘Well, the growth isn't really that good. The unemployment rate is actually higher. The CPI is actually higher.’ It is always on the negative side. It is quite common at the moment for the figures to be questioned. What do you say to people who have that?

Mr Stevens: That is a thing that is said. I think that even apart from our national tendency to want to seek the bad news and fret about it, it is a question that is often asked about data. I think that at a time of structural change,
which we are having, it is inevitable that with, as I have said before, a very large shift in global relative prices—the structure of many economies is shifting, ours included—at those times these questions of whether it is all correct are more acute, I think naturally so.

But to try to take a couple of the things you mentioned. We often get letters: ‘My cost of living is going up much higher than that CPI. How can you believe it?’ The bureau does actually compute a few different cost-of-living measures that are more tailored to particular groups. I think I am right in saying, Chris, that they have all slowed down, as well, in recent times along with the headline CPI. They are reading slightly different numbers, as they always would. We all tend—and I do too—to remember the prices that are rising, but we tend to forget the ones that are falling. There are plenty of prices falling. Petrol prices have been among them, actually, in recent months.

On the unemployment figures, I guess the way I would respond to that is that I think we would all say ‘I know somebody who has lost their job,’ or maybe more than one. What about these anecdotes? That is a fair point. But the bureau samples 30,000 households every month. They have been sampling them consistently that way for about 40 years and compiling the data in a consistent fashion over that time. There have been some technical problems with the employment data, which we can discuss if you want to—if you have a wish for that pain we can go through that. But by and large I would say that over the course of my career the labour force data have tended to be amongst the most reliable numbers. And I think with the CPI figures they are sampling 100,000-plus prices every quarter to compile that. So, we cannot claim the data are perfect, but the quality is pretty good.

I think there is the tendency we all have to focus on anecdotes, but we also have to come back to trying to measure, as systematically as we can, the big picture as well. We do not ignore anecdotes, and we do a lot of liaison, but we also have to try to fit that into a systematic assessment of the bigger picture.

CHAIR: Given the variable circumstances around the world in other economies at the moment and that there is still the possibility of shocks to come, caution is perhaps an appropriate response. Is the Reserve Bank cautious in its estimates?

Mr Stevens: It is quite understandable that everybody feels uncertain. I have begun to wonder whether we in Australia worry about the Greek economy more than the Greeks do, almost. It is understandable because people read the news, and the European problems in particular are extremely difficult problems that will take years to sort. So I think it is understandable that people feel that caution. I describe our attempts to forecast the future—and the truth is we cannot have great confidence in anybody's individual forecast, but we have to do it—as prudent estimates.

I think they are prudent estimates. The real question in forecasting is thinking about: how could the future be different to the central view? How would that unfold? And, of course, what would you do in that event? We give time internally to that sort of thinking. I would probably describe myself as cautious but optimistic. It would not be any secret to the committee that I have tried to get people to see the glass half full rather than half empty because I think we risk talking ourselves into more gloom than we really should. At times like this, it is part of my role to try to give a balanced picture. Cautiously optimistic, I would describe myself as, but cognisant that there are many hurdles for the world economy in particular to get over in the period ahead.

CHAIR: In the macro figures, there are some figures that are as good as it has ever been for Australia. When we talk our own economy we say it is good compared to everywhere else; it could be a lot worse. How does the Australian economy compare in our own history? How are we standing relative to ourselves?

Mr Stevens: My thumbnail answer to that would be that, at present, on the data we have, we have an unemployment rate of about five per cent; core inflation is two per cent; our government is AAA rated—that is a smaller and smaller set of governments in the world today—our banks are strong; and we have been given, by the global economy, a huge gift, really, by the terms of trade rise. In the history of the Australian economy, in the time I have been working as an economist, that is a pretty good set of outcomes by the standards of that history, I must say. That is not to say we should not try to do even better, but, objectively, on a historical reading, you would have to say that is a very respectable position.

CHAIR: Still on some of the more pessimistic views, this is all good, but something could happen at any moment. How resilient are we to sustain a reasonable level of prosperity in the face of more shocks?

Mr Stevens: In a public talk recently, I went through some of the things that people fret about that could happen. Bad things can happen and then it is a question of how resilient our structures and institutions are and how much policy scope we have to respond. We are still fairly well equipped to handle some of the things that could go wrong—some of the things to do with, say, the need for foreign funding of the banks. I think our reliance on that is now lower than it was four years ago when, under what you would have to say was an extreme
stress scenario globally, we coped. Because of the way the banks have changed their funding structure since then, we are probably in a better condition than we were.

People worry about house prices. This is a common question that comes up, particularly from overseas observers. I have spoken about that recently. One really never knows. At this point, house prices, relative to income, are at a ratio of four or so, which is much higher than it once was, but it has been there for about 10 years. The household sector is actually managing its debt and paying it quite well. I think we are in reasonable shape there. Those issues are routinely stress tested by APRA—what happens to bank balance sheets if something happens. Scenarios that are often gone through there involve a recession, a big downturn in house prices, unemployment goes up et cetera. The system gets affected but it remains well and truly solvent. So, yes, bad things can happen, and you are never going to know for certain how you will go if they do, but I do not see that we should not at least have some quiet confidence that we will manage. That is my view.

**CHAIR:** You have talked about the glass being half full rather than half empty: do you recall a time when we were overly optimistic, when we saw the glass as overflowing when it was half full?

**Mr Stevens:** Let me fill it up for you. There have been periods of too much optimism. If I may give a little bit of history, previous terms of trade booms were periods where we blew ourselves up. In the early 50s, when we had a fixed exchange rate and a massive terms of trade gain—it was in the farm sector at that time, not the mining sector—that inflated the economy and CPI inflation went to 25 per cent. Then the boom crashed and everything went backwards, and there was quite a deep downturn after that. In the late 70s we had a similar story.

So if terms of trade booms are not adequately handled they can engender excessive optimism and then set you up for a crunch. What is interesting about this boom—and I am the first to acknowledge that the miners would say, 'Where are the skills and the labour,' and so on, while others are saying, 'It's really hard,' and they are right—is that the overall economy has come through this without a big breakout in inflation, and I think we will come through it without a slump at the end. Key to that is a floating currency, much improved structures for macroeconomic policy and a more flexible economy generally, and that has all been said before.

Probably, as a community we were a bit overconfident about house prices—they were always going to rise and it was okay to keep gearing up. There was a lot of spending that went with that and certain sectors did well in that period. We were going to have to get a little more real there, and we have. When you look back, that change began about five years ago. We understood this a few years back, but it has taken time for the full implications of that to come to be understood. So we were a bit overconfident there, and if that had kept going we were probably headed for problems, but I think we have escaped that.

**Mr CIOBO:** You have touched upon the issue that most people have been discussing in the financial markets for some time; that is, what is happening in Europe. Given the strong and rosy view of inflation in the Australian economy over the foreseeable future, I am interested in your comments more broadly about ECB support that has been moot for the various sovereigns in Europe, and whether or not there are long-term implications for inflation that are reasonably foreseeable.

**Mr Stevens:** That is a very important question because, in anything approaching normal times, for the central bank to be contemplating large-scale purchases of government debt in the market and so on, and putting the amount of liquidity into the system that they already have—let alone what they do in the future—every textbook I ever read said that in the long run and even in the not-so-long run that would be inflationary.

I guess the thing is that we are not in anything like normal times. Knowing those guys, as I do, at the ECB and given the anti-inflation mandate that they have—and it is quite engrained in European culture—it has to be extraordinary times for them to think about this and, even within the system, it is probably not without its controversy. I think analytically the thing there is a potential downside scenario that would be deflationary. I think that is the idea, and that must be headed off, if at all possible, because that is very damaging. So what they are doing is certainly inflationary compared with that real deflationary possibility, and if they get it right they will keep inflation just positive but not high.

It is extremely hard to calibrate how much of this you do. We have come from a world where you do small changes in interest rates. There are very rough calibrations for doing that. The calibration for doing so-called non-conventional or quantitative things is being worked out as they go, inevitably. So it is very hard to know. I do think, though—and Phil may wish to add to this—that they have to stabilise the financial side, but that has to be married to and combined with clear structures for better fiscal management and better banking supervision and management over time. So the ECB is really saying: 'If the governments are going to keep their promise of stepping up to do these other things and we know that will take time, the ECB will play its part in giving support in the market in the interim.' Both those things are critical. It will not work if you do not do both. There is a sort of
coordination of who goes first and 'after you; no, after you' and that is what has been difficult. So they need a mechanism whereby everyone agrees to play their part and that agreement is credible and we can be confident the other guy will play his part, as I do mine.

**Dr Lowe:** I think we have got to the point now where the governments cannot solve the problems by themselves and the central bank certainly cannot solve the problem by itself, but together they can. What we are seeing at the moment is this kind of dance where the central bank and the governments are trying to find a way of moving forward together to solve the problem. It is very, very difficult because it is not just one government; it is 17 governments and a single central bank. But they are gradually moving in the right direction and some support from the ECB is probably critical to this whole process.

You see in Europe and also the Bank of Japan, the Bank of England and the Federal Reserve that the balance sheets of the central bank are increasing by up to 20 or 30 per cent of GDP; so it is truly extraordinary. As Glenn said, in normal times that would be inflationary. For it to actually be inflationary in the current environment, banks have got to say: 'I've got all this money at the central bank. It's earning zero interest. I want to go and do something else with it.' When they start doing something else with it, it creates pressures in the domestic economy and starts pushing up prices. That would be how it would normally work. At the moment, the banks are saying, 'I've got all this money at the central bank and I'm perfectly happy to leave it there. I can't find any other assets in the global financial system or loans to corporations that I'm happy to make on a risk adjusted basis.' So all this money is sitting there and it is not really doing very much to the global economy, other than probably forestalling a serious crisis.

The point where it could cause inflation, and I think we are a long way from that, is if banks start saying: 'Well, earning zero at the central bank is terrible. I'm going to go and look for other assets.' But that requires banks and the global financial community to start being prepared to take more risk than they currently are. Given the current uncertainties, I do not see that happening for some time.

If it does happen, the central banks are going to face a challenge in somehow locking up that liquidity so it does not flow into either lending or asset purchases in the global financial system.

**Mr CIOBO:** But therein are some real challenges, because the reality is that once the bank recapitalisation process is finished in whatever form it ultimately takes throughout Europe, there is, as you identified, very large amounts of liquidity sitting there waiting.

**Dr Lowe:** Technically, that liquidity can be locked up. We understand how it could be done. I think the ECB understands how it can be done. The question that they will face is: at what time do they start locking it up? One of the things that they will be able to look at is what is going on with domestic demand and credit in these countries. So it is not an impossible task to withdraw this liquidity. The question is whether they will be able to do it on a timely enough basis. We do not know, but I think it is still quite a long way, I suspect, before they will have to actually face that question. But when we have to face it will be a very important one to get right.

**Mr CIOBO:** Has Australia been fortunate to be placed almost in between the growth of the Asian region which has been the lighthouse for the global economy and on the other side the deflation environment of the Europeans and to a lesser extent, obviously, the Americans? Have we been sitting in a nicely juxtaposed position?

**Mr Stevens:** When I have tried to address the question: is it all luck? It is certainly not something that we created ourselves to be geographically where we are with the resource endowment we have but that is a blessing that has come to us. I think you could express it in the way you did between a deflationary risk at least in one place and extraordinary growth and at all times, until recently, actually inflationary risk in the other. We are in the real economy exposed to the strong bit, our financial economy and our psychology is still quite connected as well to the pessimism from the North Atlantic.

**Mr CIOBO:** Can I ask about the difficulty of making forecasts in the current climate and the climate that has prevailed for the past several years. If I look at some of the RBA statement of monetary policy forecasts for GDP growth we have seen some—and you have touched on this in your opening statement as well—variation between forecasts and reality. Would you care to outline to the committee some of the difficulties in making those forecasts and some of the factors that impact upon the difference between the forecasts and the reality?

**Mr Stevens:** As I said earlier, forecasting is an extremely imprecise art. There is not a great deal of science in it. It has ever been thus. There is a long history of this in literature going way back to the seventies. Some of the difficulty is—and I probably will not get this comprehensively complete off the top of my head—the future is inherently difficult to predict anyway. The recent past has actually been difficult to predict—that is, the data that we have for what has been happening. Inevitably, even the best data is measured with a margin of error. It gets revised, and so the jumping-off point into the future that you think you have today actually you find is a little bit
somewhere else subsequently. That would be true to say partly why the very near-term growth forecasts are a bit higher. That would be right, I think Chris, that the recent history got revised up a bit from what we had been told earlier. That is a difficulty.

We know that the future will have shocks. A shock by definition is an unforecasted event. We spend time thinking about what they might be, but there will always be things that come along that you could not predict and, even if you could predict they might occur, not when. It is often hard to have a good sense of how they work.

An example of that would be a current issue is: suppose there is some dramatic financial event in Europe—they muck something up and everything goes pear shaped; global capital markets retreat from risk. Usually the Aussie dollar would go down. There is then this safe-haven idea. We do not want to overstate that, but I think there is a bit of a safe-haven mechanism at work, at least some of the time. Most likely, the Australian dollar would fall. It is not inconceivable that it would actually go up. I do not think it will. That would be different to past experience. Obviously the implications for the economy could be important because, in the past, this particular stabilisation mechanism has worked in a particular way; if it worked differently in the future that could be important. So those things—acute uncertainty: the forecasters always want to say there is more than the usual degree of additional uncertainty; that is sort of a forecasting cliche. But it probably is true at times like this. That is what I would say. Chris, do you want to add anything?

**Dr Kent:** I would agree with you there. The shocks that are before us—we cannot ever know what they are. A critical part, though—and of late—has been knowing where we are coming from. The point is that it is just very hard to pin down the state of the economy in real time; it takes time for data to come through and be processed accurately and compiled together. Revisions to data are a normal part of a forecaster's life. I think the other thing is that that is all the reason why you do not rely on any one particular data series. You try and build up a picture of the economy from many different puzzle pieces, if you like, and put them together.

The other thing is that all of that can be helped by looking at not only a broad range of data but a broad range of sources—so not just the official data but the business surveys, for example; surveys of households; and our own liaison program.

**Mr CIOBO:** The prevailing mood, as I ascertain it, at the moment with respect to, for example, Australia's forecasts, both Treasury's and RBA's, is that we have seen a deterioration in terms of trade—well, you have got a cabinet minister saying the mining boom is over; you yourself have said the investment pipeline as a share of GDP is expected to peak within the next year or two. We have respected forecasters and various financial houses saying that they are expecting to see a revenue decline of $10 billion, $20 billion or $30 billion. Is it fair to say, would you agree, that the prevailing mood is that there is going to be a tapering off of what were overly optimistic forecasts by Treasury?

**Mr Stevens:** I think it is important to be clear about what the peak of the mining pipeline means. If that does reach its peak in a year or so, or a little more, from now, that is actually what we have been expecting for a while—at the bank, anyway. Probably if you went back a few years, really our forecast for mining investment would have been a bit too low, is my guess. So we have long expected that there would be a very large—I mean, you could see it happening: a big investment build up. You know that has to peak at some point. And, to be truthful, there are many possible projects. We do quite a bit of work on talking to the various companies on projects. Are they definitely committed? What stage are they up to? What is possible? What is likely, and so on. And there are a vast number of possibilities which, I think, in truth, really should not be done, because if they were all attempted—there is already pressure on the cost side for the resource companies doing what they are doing, and you probably just cannot do everything that people have postulated might be done.

So, with regard to the peak in the pipeline, I do not think we have seen any evidence lately that causes us to change the timing of that in any material fashion from what we have had for a while; that was always going to come.

It is important to remember, though, that having built up capacity to extract resources of various kinds you then start extracting them. You finish doing the investment, and probably the rate of investment comes down a bit, but the production side starts to increase. The question will of course be at what price those resources are sold. But those are the sorts of high-level contours of how I see it. I do not think, at least at this point, that I have seen evidence to cause us to mark down that side of the outlook materially. I cannot really comment on the revenue implications because the revenue is a function of not only how much is extracted but what the prices are. We have got assumptions about that, but when you are talking about revenue it is through that prism. So I am not in a position to give a comment on what the budgetary implications are.

**Mr CIOBO:** Thank you.
CHAIR: We will go to Dr Leigh and then we will have some questions from the students. So get ready, Governor!

Dr LEIGH: Governor, congratulations on what I think is a record number of students in the gallery today. I do not think I have ever seen as many students or as few journalists as you have today.

Mr Stevens: Why don't you let them down here?

Dr LEIGH: They are welcome. Some of them have made it down but not all. I want to start off with bank profitability. The BIS Shrapnel annual report this year, for the second year in a row, found that Australian banks were the most profitable in the developed world. To what extent should that make Australians feel that we need more banking competition? Or is this really just a function of other banks in other parts of the world doing poorly, rather than our banks getting more profits than they deserve?

Mr Stevens: There are certainly big challenges for banks in many countries. So, with much of this comparator group, there is not a high bar to clear. That is certainly true. I do not know that you could claim that for every country. The Canadian system, for example, is in pretty robust shape, like ours is. So there is that.

Are the profits too high and is that indicative of a lack of competition? I know we have discussed this before. As far as I know, it would still be the case that the return on equity to bank shareholders is good, but there are various other parts of the listed sector where it would be similar. So, on that test, I am not sure it would be obvious that profits are excessive—that being only one test, of course.

Is there enough competition? I know we have covered this before too. And I have said all this before, so I am sorry to sound like a broken record, but I think people want to look at this through the prism of mortgage finance, and I understand that that is very important to many Australians. But there are other things as well. What about the poor old depositors, who, for some years, were not getting quite as good a deal as they are now? There is a lot of competition to get deposits. This is actually the flipside of the thing I referred to earlier—the banks having less vulnerability on the foreign funding side than they did some years ago. That is because they have got much more domestic funding and much of that is deposits. So the depositors, with a bit of shopping around, enjoy quite considerable competition for their money. That is not something to be ignored or sneezed at.

So I think that in assessing competition it is perfectly fair to look at the provision of mortgages and, for that matter, business finance, but we should not neglect the other side of banks’ balance sheets, which is really where most of the funding comes from. So I think that we need to adopt a holistic—to put it that way—perspective.

Dr LEIGH: In terms of thinking about the labour market, I am always struck when I read the statements. I feel as though you place a little bit too much emphasis on averages and not enough on variance. I guess one of the things that naturally concern us is the variance in unemployment rather than simply the average rate. What do we know about it? The decline in the terms of trade should also reduce the patchwork economy issues, shouldn’t it? It ought to bring down, say, the variance in unemployment over time.

Mr Stevens: Yes, I think it is fair to say that, to the extent that the impetus for growth shifts away a bit from where it has been to be more broadly focused, that is probably right: you might get some reduction in the so-called patchwork. In saying that, I think it is important to say as well that it is always a patchwork. It is not and never has been a seamless garment. There is always a patchwork nature. 'Patchwork' is a new word we have coined and it is a reasonable description, but it has always been there.

I am searching in this pack here for the figures on the variance of the unemployment rate. We do track the dispersion of the rate of unemployment. There are quite a large number of regions where you can get this. One of the datasets that you can get—you know this, I know. At the moment, on the basis of the figures I have here, about half the regions have unemployment at five per cent or less; 90 per cent of them have unemployment less than seven per cent as measured; and there are very few, if any, with double digits on the most recent data. Even those numbers are themselves averages within an area, but there are no figures more detailed than that. I suppose my conclusion is that there is regional variation. If anything, I would say I am very slightly surprised that it is not bigger than we presently see. That is not to say that it might not get bigger, though, as you say, some things are happening which could lessen that tendency. So I think it is always a patchwork. On the basis of the metrics we can come up with to measure this, it is not really more of a patchwork than is normal.

Dr LEIGH: Let me move from the labour market to the exchange rate. We have seen upward pressures on the Australian dollar through demand for highly rated government debt. You have referred to the interest rate spreads, and then there has been a live debate in the press about intervention—whether Australia should go down the Swiss route and take on 130 billion euros or so of foreign exchange.

Mr Stevens: That is only a couple of months worth, actually.
**Dr LEIGH:** Yes. I was going to ask: what is the risk and what would it cost?

**Mr Stevens:** I will try to address that in two parts, because I think there are several bits there. Demand for sovereign debt by foreigners certainly has been strong. They are holding, I think, nearly 80 per cent of the stock now. It is not a very large stock, of course, by global standards, but it is attractive to them because it is AAA. It offers a yield which is extremely low by our historical standards but is quite attractive if the alternative is zero or negative, as in parts of Europe. So that is there.

I do not think it just flows into government debt, though. Any foreign capital flow into an Australian asset of any kind, in principle and other things equal, puts upward pressure on the currency. There is more official flow into Australia these days than there once would have been, but we should not forget there is a fair bit of private investment coming too into all sorts of assets, because generally rates of return overall in this country are attractive.

Intervention—we have not done any intervention intended to affect the price. I can come back, if you like, to the question of how one might assess whether the currency is overvalued or not, because it is quite a question. The Swiss case is quite unique—or at least it is very different to ours. With Switzerland they are in Europe and they have the euro you have when you do not want to have a euro. They have a very open economy, so a very large share of their GDP is in the traded sector—much larger than ours. They have consumer price deflation and they have interest rates at nothing. In fact, the Swiss curve out to a year or so is negative.

If you have deflation and you want to ease policy and your interest rates are nothing, what do you do? What they have done is, firstly, they made some very large interventions a couple of years back to try to contain the rise and then when a certain point came they announced this cap. The Swiss National Bank's reserves are now approximately the equivalent of 70 per cent of Switzerland's annual GDP. Not that anyone is proposing we do that here, but that is a very large sum of money. Our reserves are $45-odd billion, so it is a tiny fraction of Australia's GDP. Even there, the Reserve Bank has a very large open foreign currency position which has affected our earnings, as you know. It is our job to accept that. For policy reasons we cannot manage that away and we would not seek to, but they are not inconsiderable risks that the taxpayer would effectively take on with extremely large-scale intervention. In extremis you could make arguments that that should be done. But it is a big call and it is not a call that we have felt should be made to this point in time. Does that cover what you wanted to be covered?

**Dr LEIGH:** Very quickly, what would it do to inflation if you intervened?

**Mr Stevens:** It depends on whether the intervention is successful. At times that we have known in the past, interventions of reasonably substantial size at the right moment that send a signal can apparently have some impact. The kind of intervention that is trying to stand in front of a huge tide quite likely might not be that successful. If you did not have any effect on the exchange rate to speak of then inflation is not affected directly. The question then would be whether there were any indirect effects coming via the kinds of mechanisms that Mr Ciobo asked about over the longer run, if the balance sheet was expanding.

**CHAIR:** Thank you. Hannah McWilliam and James Bray might like to join us on the panel. Hannah McWilliams from Canberra Girls Grammar School, would you like to ask your question?

**Hannah McWilliam:** Mr Stevens, would you ever consider quantitative easing in Australia, similar to America? Do you think it would be an effective policy and why?

**Mr Stevens:** Would we undertake QE, as it is known? We would not do that until such times as a process of easing interest rates had got to some lower bound, whether that was absolutely zero or something a bit positive but with much reduced effectiveness after that. It could be debated, but I do not think we would undertake quantitative measures in an attempt to ease monetary policy until we had used the interest rate mechanism, because it is still the most effective one.

Would it work? That is a very interesting question. There have been experiments in this around the world over recent years. You certainly could not claim that this made no difference, but it would be rather hard to say, on the other hand, that it has transformed the outlook so far. There are going to be many PhDs written on this period as time goes by. I guess what I would say is that I hope never to be in a position of having to decide whether we would use quantitative measures. We have thought about how we would do it if needed, and if it were needed it would only be needed when interest rates had approached the zero bound. We would have the mechanisms to do it at that time, but I certainly hope never to get there.

**CHAIR:** Mr James Bray from Narrabundah College.

**James Bray:** It has been highly publicised in the media that the international community may be currently undergoing a change in the international economic superpowers. Do you believe the Australian economy will be affected by this positively or negatively, and to what extent?
Mr Stevens: It is hard to tell. Certainly there is a rise in the importance and wealth of not just the Chinese people but also the whole of Asia, where there are hundreds of millions of people whose economies are growing, who are getting wealthier, and who are a source of demand in the global economy. That is generally very much to our advantage, and that is basically that terms of trade story we have been talking about. So that is good.

There are, of course, many issues that come with this, because in the governments, or the oversight of the international economy by the international institutions, there are all sorts of questions about how we allow the emerging countries to play a more prominent role over time. That needs to be accomplished, and as it is accomplished we need to try to ensure that all the countries are on the same page about what we want the IMF and other bodies to be doing. So there are many challenges there.

Australia is a very small player—that is the truth. We are better off because of the rise of the emerging wealth of these countries, but we also have a big interest in these other issues being well managed as time goes by. We should, and I am sure we will, do what we can to help facilitate that, small though that may be.

Proceedings suspended from 10:44 to 11:00

Ms O'DWYER: Governor, thank you very much for your response to Dr Leigh's questions regarding the high exchange rate. I would just like to follow up a little bit on the line of questioning there. You have already touched upon the safe haven flows to the Australian dollar. I would like to follow up on whether there are any other factors which the RBA considers have contributed to the distortion in the dollar.

Mr Stevens: We should not presume on its face that it is a distortion, I think. The main story, I think, is that we have had the very high terms of trade historically. That has been associated—there is an observable relationship—with the real exchange rate. I think what is happening there is a sort of signal, if you like, of potentially attractive returns in this country, not just on financial assets but on the real capital stock. Investors find that attractive. There can be a kind of risk-seeking dynamic as well. Some in the financial markets regard the Australian dollar as a kind of play, if you like, on the global economy. But then, if the global economy does well, typically we would have the high terms of trade story and the high currency would go with that, so those people are really just helping to make that happen. So that is there. As we mentioned, and as I think you mentioned, I think there is more tendency now for some official flows seeking high-quality assets. I would have to say that the official investors are not usually the most adventurous; they are usually the ones that come along after others have been coming for a while. So I think all those things are at work.

Ms O'DWYER: I do not want to verbal you, but are you suggesting that there is not a material distortion?

Mr Stevens: I guess what I would say is that the fact that it is high does not mean on its face mean that you can say, 'That must be a distortion.' It could be, but let us put it this way: in the internal work that I have asked the staff for, I say: 'We have had various econometric relationships over the years. How does what is in the market now compare with what would be predicted?' For some of those it is higher than would be predicted. There are one or two models you can come up with that say it is quite undervalued. I personally would not draw that conclusion but, as with any model, you can find various answers. I think it is probably the case that on balance it looks high relative to the mean prediction of models, though the size of that gap is not especially large in comparison to other forecasting errors or ‘misalignments’ we have seen in the past. So it is a bit on the high side, I would say, but probably not dramatically so.

Ms O'DWYER: So do you see the Australian dollar then trading above fair value or close to fair value? Could you give us some commentary on that and the impact that that then might have on Australia's trade-exposed sectors and the Australian economy more generally.

Mr Stevens: I would describe it as probably at present trading a bit above where I would have thought it would be, based on these past relationships and my instinct of the sorts of things that have been happening in, say, the past six months—terms of trade have declined, global growth outlook is not catastrophically bad but it is softer than it was and so on. I am probably, to be honest, a little surprised that it is not a little bit lower than it is. But we are not talking 20c worth or something—I do not want to give figures. I would say it is probably a little on the high side, but in terms of the statistical relationships you can fit you cannot actually say that error is all that significant. It is just my instinct that suggests that it is a bit on the high side.

Ms O'DWYER: Do you think that there are any specific risks that the Australian dollar trading above fair value might pose to the economy?

Mr Stevens: If it is a long way above fair value for a long time then that is, one would have thought, unnecessarily contractionary for those trade-exposed sectors. How far above is it and for how long would be the questions. That risk clearly exists. In stepping back from the very short term, the big strategic question is whether you think that there is fundamental change in global relative prices, a lot of which is going to be persistent—not
all of it but a fair bit of it—then we will have a larger resource sector and some other sectors will be smaller to be at full employment. If that is the case then you would think that the mean exchange rate we used to see will not be seen any more and instead on average we will see something higher. I cannot really tell you exactly where that would be. If that is what you think, you still would not be sure that the exchange rate is ‘correct’, but that would colour your thinking.

If you really think the whole thing is going to go away imminently—the mining boom is going to completely crash, the relative price shift is not there, the whole thing is not going to persist—then the Aussie dollar in that scenario presumably would need to be much lower than it is. It probably will go there if that scenario unfolds—that would be my guess. But in the interim, if that was your view, you would probably be worried that it is too high.

**Ms O'DWYER:** My colleague Dr Leigh has already talked about the commentary in the mainstream media regarding intervention, so I will not touch on that. But I do want to touch on financial system stability. Depending on where you pick the starting point of the crystallisation of the GFC, whether it is the fourth or the fifth year, globally there still remains a lot of work to be done on financial system stability. I understand the IMF has been conducting a review of the stability of the Australian financial system. Can you provide us with an update as to where that is at. Given that we live in volatile times, has this review revealed any areas of concern that we as legislators should be aware of ahead of the report? Do you have any comments on the report?

**Mr Stevens:** I think what you are referring to is the IMF FSAP process which has been underway. We have met with them—I cannot recall the exact timing of that. A number of processes are done, including sort of stress test exercises and so on. To my knowledge—Phil, I am not sure if you can recall the details—I do not think there are serious concerns arising from that work. One of the questions that is always raised is the foreign funding for the banks coupled with the housing story and so on. I think we have a reasonable story there and we have given a satisfactory account of that to the IMF people. The process is not complete yet, so I cannot really say much more than that. But I do not anticipate there being serious concerns arising from that when it is finalised.

**Ms O'DWYER:** If you are going to be compiling some documents for the committee in relation to Note Printing Australia and Securency, you might include a time line showing which people were contacted and the points at which they were contacted both orally and in writing—the Treasurer, the Treasurer's office and the Department of the Treasury. I think that would be quite useful for us when you compile those documents to provide to us.

**Mr Stevens:** I will give you anything I can on that. I am not going to be able to be precise on timing at some points with the Treasurer. Certainly they were briefed orally, as I said, at one of the previous hearings in mid-2009 within a couple of days. And I have given verbal updates at moments in time since then. I cannot recall the days they were, I will not be able to do that, but whatever I can give you I will give you.

**Ms O'DWYER:** I am not specifically after days. I just want to put that into the broader context of the time lines as to the events that you have outlined to the committee.

**Mr Stevens:** Whatever I can give you we will compile.

**Mr TONY SMITH:** I will stay on that topic. Appreciating the legal processes involved and your restrictions and responsibilities in that regard, I will first go to your statement—that might be a good start. On the last page you said it is your intention to compile a folder of documents and to table it before this committee at the earliest opportunity. Have you taken advice, or do you intend to take advice, on your capacity to do that for the committee at an early date in a private in camera way?

**Mr Stevens:** I have not taken advice on that question specifically. If the committee wishes to have such a session we can head down that direction if the committee wants to consider that. We have not at this point set out specifically to do that in particular, but if you wish to—

**Mr TONY SMITH:** Thank you for that. You would appreciate that we have three hours and we have important matters of policy and governance to cover. I think it may well be useful in the future to have a specific hearing where we can deal with these matters. Can I take you back to the last question you answered in February. I will let you get that Hansard. Early in that hearing on 24 February I asked you about any direct contact with the employee of Note Printing Australia who had certain concerns and allegations. At first you said you did not think there was anything in writing. But on the very last question you said you would need to come back to that. You said you had been reminded while we were talking that the Deputy Governor at the time, Mr Battellino, who had retired 10 days before the hearing, had invited the person to put that in writing, which he did, and give it to the Deputy Governor. You went on to say that that statement was made available to Freehills. When did you first read that written memorandum?
Mr Stevens: I did not read it at that time. My memory is that it was not given to me. I have read it recently, because it is in fact part of the brief of evidence for the present proceedings, which is obviously why there is a complication in discussing it. But it was not given to me at that time.

Mr TONY SMITH: And it was not given to you prior to the February hearing? I presume—

Mr Stevens: At the time I believe that the gentleman, through his lawyers, compiled the statement that he was prepared to sign his name to and that was actually transmitted directly from his lawyers to the Freehills people who were doing the review. That is what I believe happened. I think the deputy governor may have been shown a copy at some point in the process. I cannot be certain of that, but I was not shown it at that time.

Mr TONY SMITH: I will come back to that, but just to be clear: you said in that last answer, in February, that the deputy governor invited the person to put his concerns and allegations in writing, which he did, and give it to the deputy governor. So that occurred?

Mr Stevens: Let's see if we can clarify that. Since that hearing I have had some advice on the nature of the process. I believe the process was—and it has been said in the papers—that the gentleman came to Sydney to speak with Ric, at Ric's request. That happened. Ric asked for there to be a written statement compiled, detailing these concerns. That process occurred. I understand that the gentleman wanted to do that, with legal advice from his own lawyer. That is fine. He had stipulations about confidentiality and so on. I have not spoken with Ric about the details of this since the last hearing. So I should not say exactly when or how or whether he did or did not see the actual document. What I do know is that it was compiled, it was agreed with his lawyer and my understanding is that the lawyer transmitted it directly to the Freehills people. So they had it. They did not get it via the deputy governor, as I understand it. It was transmitted directly. That is the advice I—

Mr TONY SMITH: Your statement—and I am reading from Hansard, just before our adjournment, on 24 February—said:

I have been reminded while we have been talking that, in fact, the deputy governor invited that person to put that in writing, which he did, and give it to the deputy governor.

Mr Stevens: The sequence there was that you were asking, I think, when the bank found out about this. The answer I was giving was that we became aware because one of the assistant governors sits on the board and the concerns of the gentleman in question became known to him and therefore to the bank and that is what led to the deputy governor asking to see the guy and to put it in writing.

I think earlier in my evidence on that occasion I said that I did not think that someone had written us a letter. That is what I said. I did say that and I think that is true, but I was reminded during that hearing that there was a document compiled at the request of Ric Battellino. That is this document. If I was in any way loose in saying 'put it in writing,' which he did, 'and give it to the deputy governor' that was a description of what I thought the process was. I cannot actually confirm whether a document was handed or faxed by the man—or it would have been by his lawyer—to the deputy governor. What I am quite sure of from the records I have had reviewed in the past couple of days is that there was certainly a direct transmittal from his lawyers to the Freehills team, which I think is important, because it was not coming via the deputy governor. It was going directly, which I think—

Mr TONY SMITH: I was referring to that last answer where I was quoting that it was given to the deputy governor. Can I move on, given the time restriction. At the point the deputy governor had that meeting with the employee, were you informed by the deputy governor?

Mr Stevens: I do not recall whether I was informed ahead of time. I did come to know at some stage that that had occurred and that a written statement was going to be prepared.

Mr TONY SMITH: You have confirmed you have read that written statement more recently for obvious reasons but did you read it prior to the hearing in February to the best of your recollection?

Mr Stevens: I cannot recall.

Mr TONY SMITH: You say in your statement that with respect to this the document we are talking about from the staff member at NPA was examined by Freehills as you pointed out back in February. You say, 'I have conveyed these facts to the committee over the course of questioning and previous hearings.' You do not think with the benefit of hindsight that former Deputy Governor Battellino should have volunteered that he had had this meeting?

Mr Stevens: I do not know. I think he, as far as I could see, sought to answer the questions that came. I think one of the difficulties in dealing with this matter of the committee over time is there have been questions about different periods. It has been, I think, hard to keep in mind for everyone the sequence, the various distinctions and
so on, which is why I thought it was worth trying to put that in one place here today. I felt that Mr Battellino has tried to respond to the questions the committee has had to the best of his recollection quite honestly.

Mr TONY SMITH: If we go back a year to August 2011, for instance, Mr Battellino was referring in response to some questions to the fact that the board of Note Printing Australia had taken certain actions. You do not think at that point through all the questioning over a couple of years it would have been sensible for him to say, ‘As it happens, I actually had a meeting with the person who has made these allegations’?

Mr Stevens: I suppose opinions about that will differ. What was important, I think, at the time was that there be a process of getting evidence and proper investigation. The preparation of that particular document was part of that process and an important part. I think that is the key thing. I am not going to comment on whether he should have given some piece of information that he was not asked about at the time.

Mr TONY SMITH: You do not think that in the interests of openness it would have been good for the committee to have been told that as it happens, he had met with the person who had serious concerns?

Mr Stevens: I do not know. At least what we have tried to convey is the essence of what occurred. The fact that two particular people met on a given day as part of that process—there would have been lots of meetings between various people trying to put all this investigation together. I did not feel that particular event was of the importance that you seem to feel it is. I accept that, obviously, others feel it is more important. I am sorry that we did not make that clearer earlier.

Mr TONY SMITH: You have said in your statement the bank did not believe it should itself seek to make an assessment because the Freehills lawyers were making an assessment on behalf of the board of Note Printing Australia. Your statement says:

The Bank did not believe that it should itself seek to make such an assessment.

You did not think that you had a separate duty in any way?

Mr Stevens: I think the duty of the bank, as owner of the company, is to satisfy itself that the company has a proper process going on if we become aware of issues or concerns and, in fact, that I think is the first primary obligation of the owner as you have got a board there and you want to be satisfied that they are looking into an issue that you have become aware of and I think it was appropriate for the NPA board to investigate the matters. That is not to say that the bank did not say to them, ‘Look, you’ve got to make sure you do this.’ The bank did say that. I do not think that the NPA board members would have actually needed any great hurry-on to do this. I think they, even if we had said nothing, would have acted properly. But our responsibility I think is to make sure that a proper process is followed, and that is what happened.

Mr TONY SMITH: I have been told I have just got a couple more minutes at this point, and I will come back later on, but I will just ask a couple of final questions in the time available. With respect to this Note Printing Australia staff member, the author of this written memorandum, I think you said last February that you had met him on a couple of occasions but you had not discussed this matter with him. Is that still the case?

Mr Stevens: Yes.

Mr TONY SMITH: And have you had any contact with him since February?

Mr Stevens: I have not spoken with him.

Mr TONY SMITH: Any communication?

Mr Stevens: Any communication from him?

Mr TONY SMITH: Yes.

Mr Stevens: There has been some communication from him to the bank for which I think some of that came via me. It is not about his statement in ’07. It is about the events surrounding him leaving NPA's employ in 2008. Madam Chair, I do not mean to in any way sound like we are trying to evade that but there is actually a legal question on that matter.

Mr TONY SMITH: Do not say anything more than you can.

Mr Stevens: I have not had correspondence from him or a conversation with him about this, the 2007 issues, since February. I do not think I have ever had one with him. To the best of my recollection, I met him when he came when I was chair of the audit committee back in 2004-05. He was the one of the people from NPA that came to an audit committee meeting where we were examining some of their audits.

Mr TONY SMITH: I am very conscious of the time; the chair has been generous. But you are saying clearly to this committee that you are prepared to come to a specially convened hearing if need be at the appropriate point in time?
Mr Stevens: These are obviously important matters. What I am saying today, given that there is so much controversy over these documents, is to this point what the Reserve Bank has done on these matters is cooperate with the police and keep our mouth shut because there are people on trial accused of crimes. It is, I think, therefore not appropriate for me to weigh in on these things and I know you all agree with that. So we have not thrown about documents and comments and so on. But if there is a feeling that the committee wishes to have these materials that we have, if I can possibly supply them I will because I think that is the situation we are at and if you think that it is appropriate to have an in camera session, of course.

CHAIR: Governor, thank you very much for your offer to provide the materials. The committee has not considered whether we would or would not like an in camera meeting.

Mr Stevens: That is, of course, entirely for you.

CHAIR: That is entirely up to us and we will consider that at another point.

Mr Stevens: I am, of course, really at your disposal whenever.

CHAIR: I really appreciate that, but the comments by Mr Smith should be taken as the comments by Mr Smith. This committee will consider your offer of the material now at another time. Thank you.

Mr TONY SMITH: Madam Chair, in fairness, I was asking him a question about his willingness and availability.

CHAIR: Absolutely. And the question was answered.

Mr Stevens: The answer to the question, Mr Smith, is: I feel that this committee, as I think you have said, is the oversight of the bank for the parliament.

Mr TONY SMITH: Quite right.

Mr Stevens: If you want to have a meeting with me about that topic or whatever topic I don't really think I could say no, if you wanted to have that, frankly. But it is entirely a matter for the committee and the chair how you wish to proceed.

CHAIR: That's right. That is exactly what I am saying; we will consider that at another time. I just have one question about it. It is not to the events that occurred, it is to the claims by the ABC that you misled the committee. I have read the claims by the ABC very carefully and I also read every word of evidence that you have given over the last three meetings. I want to confirm my perception that some of the statements attributed to you by the ABC are actually reported out of order and sometimes do not refer to things that the ABC claims they referred to.

Mr Stevens: Heaven forbid that the media would—

CHAIR: Honestly, if the Governor of the Reserve Bank did mislead this committee it would be a very serious matter, but so would it be if a media outlet misrepresented the evidence given to this committee in a way that was false. I will deal with that issue. I think we are then probably done with it. You made the statement: We are examining ourselves. A question would be: is there any way that anyone in the RBA ever knew anything about anything? I am pretty sure the answer to that is no.

My understanding is that that statement was made about Note Printing Australia a good year before the latest statements.

Mr Stevens: It was made about Securency.

CHAIR: Sorry?

Mr Stevens: I think it was made about Securency.

CHAIR: No, I think you will find—yes, it was made by Securency; my apologies.

Mr Stevens: I think the background is that Mr Ciobo was the first to ask about these matters. His question was: when did I first learn about the allegations about Securency. My answer was: when the papers published it. That was true. That has actually been misconstrued by many people as denying knowing anything about the events of NPA in 2007, but that is not what I was saying at all. I think we have been quite open with the committee about the 2007 matters.

CHAIR: That statement was made on 11 February 2011. There are quite a few pages of testimony, all relating to Securency. I don't think there is any reference to Note Printing Australia at all in that.

Mr Stevens: I cannot find that right here, but I still believe that the answers I gave about Securency and when I knew about it were correct. I believe that what we said about NPA is correct.

CHAIR: There were two quotes which sandwiched that quote in the ABC report:
I think I said that the bank was aware of that but that it was not in writing.

And later on:

I have been reminded while we have been talking that, in fact, the deputy governor invited that person to put that in writing …

Both those statements were made in the same hearing and the second one was a correction is something you had said three or four minutes earlier.

Mr Stevens: That is correct.

CHAIR: And they both related to Note Printing Australia?

Mr Stevens: They did.

CHAIR: That is my recollection of it as well. I just wanted to put that on the record.

Mr Stevens: There have been plenty of different recollections, unfortunately.

CHAIR: It took quite a few hours to go back and find them, I have to say, but it is worth doing sometimes.

Mr BUCHHOLZ: I am also an advocate of the glass being half full, as I said earlier on.

Mr Stevens: Of champagne—indeed.

Mr BUCHHOLZ: Champagne or vinegar, depending on what your chosen poison is. I will start with investigating what the nation's contingent liabilities are with reference to the bank guarantee deposits, their value and what we charge the banks for that service.

Mr Stevens: There are a few guarantees. There is the guarantee of wholesale funding; that is what is charged. There is the effective guarantee under the Financial Claims Scheme of ordinary deposits up to $250,000; there is no charge for that.

Along with the wholesale guarantee, for large deposits there could also be a price guarantee. I am not sure whether any of those are still outstanding. The total amount of the guaranteed wholesale obligations which peaked—I am going from memory—at around $173 billion is about $90 billion now. So some of it has been paid off.

Mr BUCHHOLZ: Yes, as it should.

Mr Stevens: Over the next year or two, that payoff I think will be accelerated because the scheme was closed in early 2010 or 2011—I forget which year. Anyhow, it was back then. Then there are the deposits.

Dr Lowe: The total value of the deposits which have been underpinned by the financial claims scheme is at the moment around $620 billion. That is down from $780 billion because you will recall that the cap on the Financial Claims Scheme came down from $1 million to $250,000, and there are still outstanding around $32 billion of state government debt, which has been guaranteed. You also asked about the charges on the bank guarantee scheme. I think to date the government has collected nearly $4 billion in revenue in guarantee fees.

Mr BUCHHOLZ: If you add up the contingent liabilities from the financial claims scheme, the wholesale funding scheme and the state government guarantee scheme, you would get a number that is close to $980 billion, which is the equivalent of about 70 per cent of GDP.

Dr Lowe: If you add up the contingent liabilities from the financial claims scheme, the wholesale funding scheme and the state government guarantee scheme, you would get a number that is close to $980 billion, which is the equivalent of about 70 per cent of GDP.

Mr BUCHHOLZ: One of the comments we received earlier was 'as good as it has ever been'. Has there ever been a point in Australia's history where we had a contingent liability that was at 70 per cent of GDP?

Mr Stevens: There have been points in our history where our actual liabilities of public debt were well over 100 per cent—during wars.

Mr BUCHHOLZ: We are not at war at the moment.

Mr Stevens: No, we are not, but the point is simply that there have been occasions in the past when not just a contingent liability existed—people did not even think about those things back then—but the actual liability that you will definitely have to pay, which is what a bond is, was extremely large relative to current GDP, as indeed it is in some countries now and as is quite common in periods of conflict. The point to make here is that in providing insurance—and that is really what this is—there are other things to say. Firstly, all the cars of Australia are insured but the insurance company does not have assets equal to the total value of all those cars because they are not all going to crash on the same day. So it is the expected amount you pay out, not the gross number of what you have said you have guaranteed. This means it is not as simple, to my mind anyway, as adding the deposits
which are guaranteed to a stock of government debt which is a real obligation that you must repay when it falls due.

The second point is, regarding the way the Financial Claims Scheme works, if an institution is wound up—and that is the setting in which the scheme would be used—the assets would repay the depositors first, or they actually repay the scheme first because the scheme is paid out to the depositor. If there are not enough assets to cover the obligation of the scheme and therefore the public purse pays out, then I think a levy can be put on the rest of the industry. So there is a funding mechanism there to assist the government to pay.

My final point is broader. Let us suppose you did not have any guarantee at all. The truth is that, if the financial system got into incredibly big strife and large institutions were on the brink of failure, it is pretty unlikely that a government could stand by and allow that. Something is going to be done. In that sense, there is always the potential for some obligation to come on to taxpayers, I think. It is important to minimise the probability of that, and that is what a lot of the regulatory reform work around the world is about at the moment, but I doubt that you could ever make that go away. So, even if you did not have an explicit guarantee, you cannot just assume that there would never be any possibility of the taxpayers being on the hook in a big enough crisis. I do not think you could really make that assumption.

Mr BUCHHOLZ: No, but the risk, however low, as you indicate, is substantial enough that you put a value on it and charge?

Mr Stevens: The government did charge for the wholesale guarantee—

Mr BUCHHOLZ: Four billion dollars.

Mr Stevens: I think it has proved to be quite a nice earner for the Commonwealth, because I think the probability of ever paying out was extremely low, and they were quite well paid for the risk they took. If the argument is that there should be a charge for the deposit guarantee, I personally am not averse to that idea. That is not what was decided. Some countries do and some do not.

Mr BUCHHOLZ: Could I get a point of clarification? Is the 70 per cent debt to GDP inclusive of the current debt or is it just those issues that I have raised with reference to contingent liability, which equate to 70 per cent of—

Mr Stevens: No, the figure Phil quoted was the summation of net debt plus the number that you wanted to add, which I personally do not think you can add, but that is the calculation you wanted.

Mr BUCHHOLZ: Thank you. If we extend that with reference to the states' debt, our current net debt and our interest component, following on from comments earlier—'It is as good as it has ever been', referring to the economy—I want to ask about the rating agencies. At the moment how do we hold, with the contingent liabilities, the debt and no money in the bank, a AAA credit rating when there have been points in our history when we had money in the bank and no debt and yet did not hold that credit rating?

Mr Stevens: On the states—just to get the facts there—that adds about two per cent of GDP to the stock. It is not a very large number. That is the state government guaranteed debt that you mentioned. The credit rating is a rating of the Commonwealth government's capability of meeting its obligations.

Mr BUCHHOLZ: Sorry—just before you go on—the figure that you gave me on state debt was $32 billion. I think Queensland's peak debt alone is forecast to be $100 billion.

Mr Stevens: No—what you were asking was: what has been guaranteed by the Commonwealth?

Mr BUCHHOLZ: Yes. So, in this case, when I am referring to state debt, as a nation, I do not want the answer, because it is the accumulated debt of all the states, which I believe will be closer to, say, $400 billion. With that amount of debt, which did not exist in the past, along with our current debt position from a credit rating perspective, why is it that we now hold a AAA credit rating—which as a nation we should be proud of—when we did not hold it in the past when we had money in the bank and little or no debt?

Mr Stevens: Prior to the mid-80s we did have a AAA credit rating for our whole history. Actually there were plenty of times in that period where we had much more debt on the public purse.

Mr BUCHHOLZ: Sorry, we did have a AAA credit rating?

Mr Stevens: Yes. Australia was downgraded in the mid-80s.

Mr BUCHHOLZ: The Treasurer would have us believe that this is the first time in history we have held it.

Mr Stevens: I cannot comment on what the Treasurer said, but the facts are Australia had a AAA rating until the mid-80s. We had downgrades and we were upgraded some years back now. But for most of our history, and
rightly so, we have had a AAA credit rating. This country has never defaulted on a payment. There are not many countries that could claim that.

Dr LEIGH: Not even in the Depression.

Mr Stevens: No. That is correct. We should have a AAA credit rating. I would say we should never have been downgraded really. The rating is about the Commonwealth's ability to meet its debt and they would take into account, I assume, the potential contingencies of things that could go wrong. If you want to say we have to add all the bank deposits we have to do that in all the other countries too that makes an almost incalculably large number for countries whose government debt directly is 100 per cent of GDP and then you would have to add the deposits. It is a very big number. That is not a piece of analysis I would support but, if you want to do that, then I think you have to do it to all the other countries and so would the ratings agencies. Then ratings are relative.

Mr BUCHHOLZ: Do they apply a comparative rating whereby the last rating agency comes on board as a result of other economies softening?

Mr Stevens: I am sorry I do not understand.

Mr BUCHHOLZ: Do the ratings agencies apply a comparative rating globally and so, as a result of all European markets softening, did we pick up that last AAA credit rating?

Mr Stevens: I said it is relative. It is not all relative. I think they are attempting to make an absolute judgment. My point was: you have to do like with like comparisons across countries. But because someone else gets downgraded we do not get upgraded.

Mr BUCHHOLZ: So it is not comparative.

Mr Stevens: It is an attempt to gauge your ability as a country to meet your obligations.

Mr BUCHHOLZ: You commented earlier on the resources sector. Do you have an opinion, on the back of BHP's decision with reference to investments and other resource sector groups in recent days—and South Australia in particular—on the integrity of the value of the capital expenditure pipeline?

Mr Stevens: I could get Chris to quote numbers on the dollar figures. You are referring to the Olympic Dam?

Mr BUCHHOLZ: Yes, to the Olympic Dam, but not specifically that. I just use that as the example. I assume we have about $700 billion forecast in CAPX to come online. Do you have an opinion now on the integrity of the pipeline value?

Mr Stevens: You mean is the value of the likely pipeline changing in our outlook? Is that what you are asking?

Mr BUCHHOLZ: Yes.

Mr Stevens: I do not think we have seen anything in recent times that causes us to materially revise our expected profile.

Dr Kent: Roughly speaking, for our mining investment profile, we think that will peak at a bit over nine per cent of GDP. That is equivalent to about $145 billion per annum over the next two or so years. That sort of underpins our forecast. Then it is important to distinguish between different types of projects and how we come up with these sorts of numbers. There are really two types. There are those which big resource companies have made a very strong commitment to, and many of those are already underway. Those commitments are often based on very significant contracts for a long period of time, particularly in LNG, which specify how much volume of the product they will be supplying to their buyers. They are very locked in, in a way, if you like. Then there are a number of other projects—

Mr BUCHHOLZ: In my definition, I would not refer to them as 'pipeline'. They are currently constructions underway. Pipeline investment—

Dr Kent: To the extent that they are not yet finished, that is what people refer to as being in the pipeline still. Then there are things that might come into that pipeline and are under consideration. That is not just speculative. These companies are looking seriously at deposits and trying to work out what the economics of these are: Do they have the finances? What is the timing of their investment profile? What we have done in taking public information and talking directly to various companies is try to make a rough assessment of what share of these uncommitted projects that are still under consideration might go ahead in a reasonable period of time. The latest ones that have pulled back and said that they are going to delay making a commitment—they are large in terms of billions of dollars but spread over a number of years—are, as the governor suggested, noticeable but they are fairly immaterial in the 9½ per cent of GDP that we are forecasting in terms of the peak. They are in the order of
0.1 and 0.2 per cent. The recent announcements of pulling back from making a firm commitment are in that sort of order of magnitude.

Mr BUCHHOLZ: Thank you for that. With the Chinese markets slowing and our commodity prices falling or steadying, is the fiscal position of the Commonwealth as strong as it was five years ago?

Mr Stevens: I am not really in a position, I do not think, to offer commentary on the fiscal outlook and changes to it that may be in train because of what is going in China. I am not across the revenue figures well enough to know that.

Mr BUCHHOLZ: Thank you.

Dr LEIGH: Just to clarify something, Governor: the Treasurer has been saying that this is the first time that Australia has had a AAA credit rating from all three major credit agencies. That is correct, isn't it?

Mr Stevens: I do not know. I have not been back and checked how many agencies there were in the past. I do not want to comment on things that the Treasurer said. My point remains that for most of its history, apart from a period from somewhere in the mid-nineties through to about 10 years ago—I cannot remember when the upgrade happened—Australia has been known as a AAA country, and so it should have been.

Dr LEIGH: Let me move to inflation and productivity. You get almost an entirely different view of inflation from reading the statement on monetary policy than you would from reading the tabloids or listening to the political debate. The statement on monetary policy talks about a two per cent on tradeable prices underlying inflation to its lowest level in the late 1990s. Dr Lowe has given speeches about manufactured goods staying the same in nominal terms for a decade. Yet the public debate is very much about the rising costs of living and the rapid increases in prices. You pointed to one explanation for this a couple of hearings ago when you said that maybe this has to do with there being salient and non-salient prices. Salient prices are things you buy regularly or for which you receive bills; non-salient prices might be lumpy purchases, whose prices you do not really know or have in the back of your mind. Is that the best explanation for this? Do you worry about the way this might affect inflation expectations if public perceptions of inflation are out of whack with what you are saying in the statement?

Mr Stevens: I have not seen evidence of late to suggest that there is a dislodging of inflation expectations. On everything we can measure they look like they are fine—as described in surveys or by those involved in wage negotiations and so on. There is always prominence given in the media to the things that have gone up. When petrol prices rise, that is very prominent. They have been falling in net terms, I think, over much of this year. I have not read all that much about that in the media. People are invited to focus on the news that is bad. That is the nature of things. We can lament that, but I am not sure we have much hope of that changing. But I do not think that at this point we have a significant problem with inflation expectations being excessive, as best I can judge.

Dr LEIGH: In terms of the policy impact, are you still happy that the carbon pricing effect is about 0.7 per cent on the headline rate and about 0.2 per cent on underlying? You have not changed your views on that since the carbon price has come into effect?

Mr Stevens: Chris, can you—

Dr Kent: Sure, I can speak to that. Our estimates are essentially based on the earlier Treasury modelling—the detailed micromodels that came up with about a 0.7 percentage point effect on headline CPI. Because that falls quickly on things like electricity and gas in the first quarter and the September quarter of this year, those will be trimmed out of the underlying measures of inflation, if you like. So the underlying inflation is increasing by less than that magnitude. Our estimates are that a bit less than half of that 0.7 will still come through in the underlying, but that is a slower process over a period of a few quarters.

Dr LEIGH: Which would make it of the order of the effect of the banana price rises on CPI, presumably.

Dr Kent: I have not looked at the specifics, but perhaps even less.

Mr Stevens: The only difference being that it is permanent, not temporary.

Dr LEIGH: Yes, absolutely. Thinking about productivity, you have noted in a recent publication that there are signs that productivity growth has picked up over the past year. To what extent do you think that is within-sector productivity growth? The huge challenge with this seems to be that we are seeing massive compositional changes, so a lot of what we see in productivity is actually just changes in sectors or the mining sector being in an investment phase rather than an output phase. What are your views on the productivity pick-up?

Mr Stevens: I think it is a bit early to write home too much about this, because productivity is notoriously difficult to measure, for a start. Secondly, to be confident you have to have low-frequency data. We were not really sure we had a slowdown in productivity until some years after it had actually begun, and I can remember
being in this committee on some occasions saying, 'We can't be sure yet.' So I would caution against drawing too much. Having said that, personally I think it is to be expected that we will see higher productivity growth performance in this period, because I think that is really what structural change is. It is almost the definition of it. So I think it is happening, and I think we will look back eventually and see it in the figures. How soon that is, though, is very hard to say. So my judgment would be that I believe it is likely to be happening.

**Dr LEIGH:** In terms of the crowd-out effect of the resource sector on other sectors, you said in your opening statement today that, once the peak of mining investment passes, we ought to see a pick-up in construction. Presumably there you are thinking about an alleviation of skills shortages in parts of the non-mining construction sector. Is that what you had in mind?

**Mr Stevens:** It is partly things like that but it is also partly that dwelling construction has been unusually low. Even with the lower estimates of population that we now have it strikes me as unlikely to remain that low in time. It has already been unusually low for longer than I would have expected. That is not a very scientific explanation, other than that something is that low has to come up at some point unless something is stopping it.

So there is that, and I would imagine there would be some other types of non-residential building construction presently, so that in due course it will pick up. That is the kind of thing I have in mind. I do not have a precise profile of that in my head. It would be in the forecast, and I can ask Chris to articulate if you want, but that is the kind of thing I have in mind. There is this crowding out dynamic, as you say, to some extent—I think that is right—but it is not only that.

**Dr LEIGH:** That is interesting. I had in mind that the optimistic type of story one might tell is that the mining industry is the most labour-intensive in the construction phase, and then, as we move into the output phase, that alleviates some of the huge pressures you see in the difficulty of getting building—

**Mr Stevens:** That is a very valid view.

**Dr LEIGH:** Is your general view of the mining sector that it will move from being price driven to being volume driven? That is a simplistic line that gets bandied about—does it seem broadly right?

**Mr Stevens:** I am not sure what you mean by that, but I think the high prices have called forth capacity expansion. I would also say that views about the future pace of demand and reasonable assumptions about future prices and profitability at those prices have called forth capacity expansion. That is what the resource companies would be basing their plans on. Other countries will also be expanding their volumes, so supply is going to respond. That has always been understood and that is why we have always assumed that the very high prices that we have seen over recent years are not the long-run, sustainable prices. If that is what you mean by price driven to volume driven then, yes, I agree.

**Dr LEIGH:** Yes. I was thinking: lower prices, higher volume—total output not that much changed.

**Mr Stevens:** Real GDP would be higher because the tonnages will go up. The nominal value of the community's income is the price plus the volume, so if they are moving in opposite directions it is less clear.

**Dr LEIGH:** In all of this, of course, you basically just have the one instrument—

**Mr Stevens:** We do, yes.

**Dr LEIGH:** We have fiscal policy as well. I know you are appropriately cautious in talking about the right role for fiscal policy but, given what you have said about patchwork pressures, how should we be thinking about appropriate fiscal policy for sectors affected by Dutch disease?

**Mr Stevens:** You are beyond my competence, I think, in that question. With respect, I will let that one slide along to the keeper.

**Mr CIIOBO:** I observe that your term expires in September of this year, and with answers like that—

**Mr Stevens:** Next year.

**Mr CIIOBO:** Next year, sorry.

**Mr Stevens:** You will have to put up with me just a couple more times.

**Mr CIIOBO:** It looks good for you. It always turns into a bit of a fruit salad at the end, but I want to turn your mind to the payments system. I noticed the payments system board made some comments in a release earlier with respect to multifunctional cards and multinetwerk debit cards. Given the direct impact this has on consumers, I have been slightly critical of the intervention that the Reserve Bank made with respect to interchange fees on four-party schemes.

I note now the bank appears from the reports that I have read and the release to harbour concerns about whether or not EFTPOS is able to take advantage of R&D that four-party schemes have taken with respect to contactless...
payment systems. Is that a fair criticism of your starting point? Do you have a general view about the IP that is being developed by the four-party schemes and whether or not EFTPOS should be able to some extent piggyback off their contactless payments systems et cetera?

Mr Stevens: I do not have a strong view about the IP issue. The board's starting point simply is that the ability of a card to function in more than one way is a good thing. If at all possible, we would like to see the industry find a way of having that occur. I do not wish to rush in with some kind of regulatory intervention. I am not inclined that way, if I could avoid it, which is why we have kept pressing them to see if they can.

My colleagues left and right who are not responsible for these matter anymore know a lot more about them as it turns out. The issue that is arising with contactless is the ability for some of the schemes to reduce the ability of the merchant to help steer the consumer by networks—I think that would be right. Our position has been that, while the four-party schemes have got fine products, a legitimate business model and so on, we have a concern to make sure that the consumer and the merchant are suitably empowered with choice as well. This is a potential issue in the contactless because it is kind of preprogrammed to go through one network.

A lot of the debates come down to, I gather, the piece of plastic. Who owns that real estate? Whose logo can be there, and so on? Every party seems to claim, 'Actually, I own it.' The schemes would claim it. EFTPOS would claim they have got a right. The issuing bank would claim their right.

The outcome that would be good for consumers is to have a card which could function through more than one network where no particular provider is in some way unfairly advantaged by the location of the their logo or whatever. I accept that investment that has been made has the right to earn a return. Equally, people who have a valid contribution to make of their own should not be put in a position of being artificially excluded from the card. They are the kinds of things I think are relevant here.

What I would hope is that the various players could come to a reasonable agreement on how they will share the real estate and each one earn an appropriate return without disadvantaging others unfairly. I very much hope not to get involved in this but I fear from past performance in payments matters and trying to get the industry to all agree is not altogether successful often.

Mr CIOBO: It seems fundamental to me that, given the industry has, through the issuing banks as well as through the four-party schemes themselves, heavy promotion of contactless payment systems, it is a way of paying the future for lack of a better term. The default credit option in the payment network is unlikely to change. If I put myself in the shoes of a four-party scheme operator, by definition, if I am then requiring consumers to elect whether it is a credit or a debit option using the EFTPOS network or the four-party scheme network, it is eroding from the entire point of the contactless payment system. I am trying to get a better understanding of what the RBA's expectations are for that particular industry to reach an agreement as you said?

Mr Stevens: I think that from a public policy point of view it remains the case that the EFTPOS scheme is the cheapest one for society to use; it carries the lowest costs. Other parties, of course, have the right to offer their products, and if they are better products or are preferred by consumers then consumers will use them, and that is fine. We simply are alert to the possibility of a set of outcomes which end up leaving the cheapest scheme for society to use; it carries the lowest costs. Other parties, of course, have the right.

Mr CIOBO: I understand that, but this is a fairly fundamental point because you are talking about a technology platform. Whilst I wholly support the public policy goals of it, I am also interested in how it is possible for an operator who has rolled out and invested in R&D to then potentially see at the hands of the regulator an erosion of the potential return on that because it is a technology platform that is arguably superior to, for example, a traditional method of swiping and then electing which network you want to use.

Mr Stevens: I guess it is superior in that it is quicker, but I am not sure I would define it as superior in the total sense of still allowing the same amount of trust. That is the thing.

Mr CIOBO: I concede that.

Mr Stevens: So it may be impossible to solve this problem, but I think we should try. Yes, people make investments and seek a return, but the EFTPOS scheme also makes investments. It is not for me to particularly take their side at all. They are a private entity. I think it is in the interests of the country for there to be more than one payment system competing, and I know you agree. So it is not for us to so much take their side at all, but everybody makes investments, and public policy interventions—I am not saying we will make one—from time to time do affect returns on investments people have made. Public policymakers therefore should be extremely careful and balanced in how they make such interventions, and we are committed to doing that, but I do not think you can promise that, because somebody has made an investment, we could never have an intervention that might
affect the return on that. Otherwise there would be a whole lot of public policies across a whole range of fields that would be completely hamstrung.

Mr CIOBO: Sure.

Mr Stevens: Fairness and balance of process and so on are very important, and the payments process is incredibly elaborate. Anyway, what we are trying to find is an appropriate balance and the retaining of choice for consumers and, if possible, the ability for them to still choose the lowest cost system if that is attractive to them.

Ms O’DWYER: I have a couple of very short questions. Governor, I know we have had lots of discussions about the historic high terms of trade over this meeting and many other meetings. Yesterday, though, the resources minister, Martin Ferguson, declared the end of the mining boom. We had that contradicted by the Prime Minister and the finance minister, who said there is a long way to run in the mining boom. I notice that in your opening statement you talk about the fact that commodity prices have declined and we have seen the peak of Australia’s terms of trade. Given your response earlier to a previous question about the budget implications for the slowing or the lowering of commodity prices dependent on assumptions—if I am not verballing you there—does it concern you that there is going to be a significant change in our structural budget position as a result of this volatility?

Mr Stevens: The terms of trade are declining. They have declined about 10 per cent, I think.

Dr Kent: Thereabouts.

Mr Stevens: And they will decline further. That has always been assumed. I am not saying that it is perfectly on track at every moment, but it has always been assumed, certainly by us, that the terms of trade would peak and then decline. In fact, we called the peak years ago, and it has turned out much higher. But, anyway, there it is. I think it would be the case, wouldn’t it, that some decline in the terms of trade is assumed by the Treasury in putting together the budget estimates?

So the real question would be whether what is happening or what could happen is different to that. There would be a second question as to whether mapping the terms of trade and the economic assumptions into the revenues—that relationship—still works the way it did in the past. That can change. Those are the issues for them but I do not know where the revenue estimates are up to. It is not my business. My only point is that I am sure they would have been assuming some kind of profile for the terms of trade going down.

Ms O’DWYER: My understanding is that it is about 30 per cent off since the budget, so I guess my question to you is—

Mr Stevens: Thirty per cent?

Ms O’DWYER: I do not have the figures directly in front of me, but—

Mr Stevens: Is that for the terms of trade or some revenue item? The terms of trade are down. They might be a bit below—

Ms O’DWYER: They are estimates in terms of what—

Mr Stevens: the budget estimates but 30 per cent sounds a lot.

Ms O’DWYER: I will have to clarify that because I do not have it immediately in front of me. It was in response to your question earlier. Broadly, would this be of concern to you and to the RBA?

Mr Stevens: What is important with the budget—I think we have canvassed some of these matters before—can be thought about in two dimensions. There is, kind of, managing demand in the economy year to year and the effect that swings in the budget can have, because we obviously have to do our best to take account of that in forming our view of the outlook and setting our policy. Then there is the separate question of the long-run sustainability of the whole public finances. On that matter I am not an expert in these things but I have noticed that current and former Treasury secretaries have had some things to say about the long run, with demands on the public purse and the need to have revenue to fund that.

It is, in principle, a concern if the country ever got to an unsustainable position. We are far from that right now. But people who know more about this than me, talking about the long run, would think that those views would be very much worthy of careful attention, I would say.

Ms O’DWYER: I am conscious of time. I have one final question to ask you. I know previously you have talked about how the RBA spends a lot of time talking to business, getting their insights and getting their views. Obviously, there are a number of business figures who have talked very recently about how they have gone about making investment decisions. We have had quotes from people like Marius Kloppers, who have said things like:
As a country and as an investment destination, arguably the biggest change has been the terms of trade, which is the impact on the currency and so on. But aside from that, all of the other things like increased operating cost, carbon taxes and so on have all conspired to turn this from a fairly low-cost environment and therefore competitive to a higher cost environment.

You have had comments, as well, from the chairman of BHP, Jac Nasser, who said:

…growth in development activity has driven higher operating and investment costs … Australia is increasingly one of the higher cost countries in the world.

Given the discussions that you have been having with business, is this consistent with what you are hearing from business?

**Mr Stevens:** Yes, I think business in the resource sector would be concerned about skills availability, escalating costs of inputs and so on. I think that would be broadly the case, would it not?

**Dr Kent:** I think that is right, Governor. Part of it is just the exchange rate. Wages have been growing relatively rapidly but the exchange rate is up, and these are companies measuring their costs in US dollar terms. So their costs automatically go up when the exchange rate is high. Part of it is wages and part of it is just the difficulty getting the skilled labour and getting on with projects, when there are so many projects to be done in a relatively short space of time.

**Mr Stevens:** When you just think about resource sector investment averaging between one and two per cent of GDP for 50 years or so and it is going to be nine, you can see that this is a big thing being attempted. That is with, on our assumption, some projects which have been mooted but will not happen—cannot happen, really, because it cannot all be done. So at one level it is not really very surprising that cost pressures arise when you are doing this much. I suppose the point they are making, and that you are making, is that we need to be careful not to add any more to that than is necessary. That would be right.

**Ms O'Dwyer:** I am interested in touching on regulators, both globally and locally, and forcing banks to add capital and liquidity holdings. Do you think that these measures could in the future limit the ability of banks to lend? Do you think this will have an impact on credit rationing?

**Dr Lowe:** I think that, ultimately, what we will see is financial intermediation becoming more expensive. Banks will have to hold more capital, they have to hold more liquid assets and they have to raise more long-term liabilities, and that means more expensive financial intermediation. Of course, that is not necessarily a bad thing because many people would look back over the past decade and say that financial intermediation became too readily available and too cheap, and the result of that was too much leverage. I think it will become more expensive, but that is not necessarily a bad thing. Australian banks are well-placed to deal with this. Compared to most other banking systems around the world, their capital deficiency relative to the new guidelines is very small. The main issue for them is the liquidity arrangements, but new arrangements have been put in place to deal with that. Australian banks can manage. They are well-placed to do this—much better placed than many other banking systems in the world. But I think we are looking at more financial intermediation. That is the choice our society, through the regulators, is making. The arrangements we had before did not deliver a very good outcome for the citizens of the world. We have to change that. We need to recognise that we will pay more for financial intermediation.

**Mr Buchholz:** I refer to earlier comments in your opening statement that consumption spending has been stronger over the first half of the year, in part due to government compensation payments. Where you have increasing cost-of-living pressures, increasing utility costs and a flattening out of retail activity and you take consumption into consideration, can you pull out the government compensation component and do an evaluation of the real position, and then take away the cost-of-living pressures?

**Dr Kent:** It is not a precise science. The first thing is that retail sales turnover has been growing relatively steadily for quite some time, so that is a values concept. That is partly on the back of, in some parts, good discounts. In terms of the household assistance payments, it does appear, in our liaison and just looking at the numbers that the Bureau of Statistics publishes, that in May and June there was some extra spending possibly associated with that. It is a small part of the total amount of the payments, though, that was spent. As best we can tell, in July there has been a bit of pullback from that. So there has been some effect in the retail sector from these payments.

**Mr Buchholz:** With reference to the increased cost-of-living pressures, can you evaluate that in your consumption data?

**Dr Kent:** Yes. That is the difference between the values estimate—the turnover, the dollars coming through the tills of stores and the like—and the volumes estimate, the quantity of goods and so on going out the door. There are estimates of what those prices are doing. In some parts of retailing, competitive pressures are quite...
intense and margins look like they are coming down, and prices are not always going up but are coming down for some goods, particularly things like electronics, for example.

**Mr BUCHHOLZ:** When you are capturing the retail data, you are not capturing the profitability of the retail market. You are capturing dollars through tills.

**Mr Stevens:** Turnover.

**Dr Kent:** It is turnover.

**Mr BUCHHOLZ:** So if they are running at a loss it could still be captured and perceived as growth in the retail sector.

**Dr Lowe:** Sure, but the turnover—

**Mr Stevens:** Spending by consumers is growing. That is what it is telling you. It is not telling you whether the growth was profitable for the person selling or not. That is measured in a separate part of the national accounts, but the consumption is: what am I spending in the shops?

**CHAIR:** We will invite our students to ask questions. Georgia Antonopoulos from Canberra Girls Grammar School, you get to be deputy chair. Vivian Chan from Narrabundah College and Guy Lemmon from Canberra Grammar School are our newest committee members. Our first question is from Georgia Antonopoulos.

**Georgia Antonopoulos:** Governor, what long-term inflationary and employment impacts do you expect on the Australian economy resulting from the growth of the Chinese domestic economy?

**Mr Stevens:** The growth of the Chinese economy has been and will I think continue to be what we would call expansionary, so it adds to demand on us from abroad, particularly for the natural resources and so on we have been talking about. Other things being equal, that is expansionary and adds to demand. It potentially adds to inflation, but then the economy adjusts to that by having, say, a higher exchange rate that helps balance out those forces. So the initial force is expansionary and inflationary, but then once the adjustments occur we remain in balance. That is how it is supposed work in theory, anyway.

**Guy Lemmon:** Mr Stevens, earlier you referred to this safe haven mechanism in the event of an external shock to Australia. What are the features of the economy that allow this appreciation to occur, and why is this not necessarily offset by a deterioration in the terms of trade, especially given that the Australian dollar is traditionally considered a commodity currency?

**Mr Stevens:** What you have put your finger on is two forces that might work in opposite directions. You are right—in financial markets the Australian dollar has often been seen as a 'commodity currency', so it goes up and down with commodity prices, which is why the positive association between the terms of trade and the exchange rate can be observed so clearly in history.

Safe haven demand is a different thing. It is, 'The world is risky—I have to go somewhere safe.' We typically in history would not have received those sorts of flows. Historically, we were the places you ran away from when risk was perceived as growing. There are still some people who behave that way and I think on a high-frequency basis, day to day, it would still be a case of, 'We feel better today about risk—we'll buy Aussie. Tomorrow if we're risk averse we'll sell.' That is still probably quite a dominant dynamic on a daily basis, but the safe haven stuff is lower frequency, longer term. That has been occurring.

I think it has been mooted in the papers that the Swiss National Bank has bought some Australian dollars. We believe that to be true. We never thought I would ever see such an anti-inflationary, conservative institution as that hold our currency as part of its reserves. It is a remarkable thing, but it is a picture of how bad the world is in Europe, how many reserves they are buying and our relatively better showing in these league tables than we once had.

It is conceivable that you could get terms of trade falling but there is some event that causes safe haven flow towards us. I do not actually think that will happen. You can imagine it, but most likely if the terms of trade fall a lot then the currency will go down, I think.

**Vivian Wei-Heng Chan:** Despite the recessionary conditions in the eurozone, some of the traditionally stronger Western European economies maintain a higher GNI per capita than Australia's. What does that suggest about our long-term business or economic focus?

**Mr Stevens:** You are saying that the level of gross national income in Europe is still higher?

**Vivian Wei-Heng Chan:** In some of the Western European countries, yes.

**Mr Stevens:** In some of them—probably fewer as time goes by. Really your national income ultimately is a function of your productivity. We have also had a boost. If you do our real gross domestic income, the terms of
trade going up boost that quite a lot, and they have done. Right now, with the terms of trade coming down, it is shaving some off. But, leaving terms of trade fluctuations aside, there is really only one other source of living standards, which is output per hour worked, multiplied also by the number of people who are working. That is what the community's income comes from, really. Those countries that have a higher capital stock or are better at using their capital stock with their labour per hour than we are—that is, they are more productive—would have a higher national income. So really that is the ultimate challenge in economics: how do you get a higher standard of living? The answer is productivity.

CHAIR: Thank you very much, and thank you to our three students. I thank the governor, Dr Kent and Dr Lowe for attending today and for the evidence they have given.

Resolved (on motion by Ms O'Dwyer):

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

Committee adjourned at 12:32