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**HOUSE OF
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STANDING COMMITTEE ON ECONOMICS

Reference: Reserve Bank of Australia annual report 2008 (second report)

FRIDAY, 14 AUGUST 2009

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HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON ECONOMICS

Friday, 14 August 2009

Members: Mr Craig Thomson (*Chair*), Mr Andrews (*Deputy Chair*), Mr Bradbury, Mr Briggs, Mr Fitzgibbon, Ms Jackson, Mr Morrison, Ms Owens, Mr Anthony Smith and Mr Turnour

Members in attendance: Mr Bradbury, Mr Briggs, Mr Fitzgibbon, Mr Morrison, Ms Owens and Mr Craig Thomson

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2008 (second report)

WITNESSES

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LOWE, Dr Philip William, Assistant Governor, Economic, Reserve Bank of Australia 1
STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia 1

Committee met at 9.26 am**BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia****LOWE, Dr Philip William, Assistant Governor, Economic, Reserve Bank of Australia****STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia**

CHAIR (Mr Craig Thomson)—I declare open the hearing of the House of Representatives Standing Committee on Economics and welcome representatives of the Reserve Bank, members of the public and the media. I would also like to extend a welcome to the students and staff from the Sydney Secondary College, Domremy College, Fort Street High School, Monte Sant'Angelo Mercy College and SCECGS Redlands.

In response to the global financial crisis, the Reserve Bank has reduced the policy cash rate to three per cent. This has put cash rates at historic lows. The Governor of the Reserve Bank has commented that the Australian economy is performing better than most of our peers through this crisis and the initial economic aftermath. The committee will explore with the governor what contributing factors have assisted the Australian economy to fare comparatively well in such a turbulent global economic environment.

The committee will inquire of the RBA the short- to medium-term outlook for the economy, and the risks and opportunities that exist. In particular, the committee will seek elaboration on employment trends and forecasts for underlying inflation. In addition, the committee will discuss with the governor his comments about the challenge of ensuring that the current low cost of house finance is translated into more dwellings, not just higher prices.

There are great challenges ahead for policymakers as Australia comes out of the global recession, notably, how to reach a balance between preventing the property market overheating, causing an asset bubble, and the effects that tightening monetary policy may have on the real economy, in particular, on employment. In the past decade, productivity in Australia has slowed and over the last six years average productivity growth has been lower than in any other equivalent period in the last 16 years. Increasing productivity growth is one of the keys to assisting the Australian economy to recover. The governor has stated the importance of maximising productivity growth, and the committee will discuss with the governor possible strategies that could be implemented to increase productivity in the Australian economy. The committee will also seek an update from the RBA about the payment systems reforms.

Once again, on the half of the committee, I welcome the governor and senior officials of the Reserve Bank to today's hearing. I remind you that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as contempt of parliament.

Mr Stevens, would you make your opening statement before we proceed to questions?

Mr Stevens—Thank you, Mr Chairman, for the opportunity to meet again with the House Economics Committee. When we last met with you, in February, international financial markets

were stabilising after the extreme turmoil of September and October 2008, but the fallout of those financial events for demand, production and trade flows around the world economy was only then starting to become apparent in the hard data. Household and business confidence around the world had been severely damaged. Households had sharply pulled back their discretionary spending and were tending to try to save more and to pay down their debts. Businesses had responded quickly to a fall in demand by cutting production and costs as well as shelving plans for expansion.

It was already clear by February that the resulting contraction in economic activity in the December quarter had been severe in many countries and that global growth had suffered its biggest setback in decades. Global trade was falling rapidly. Our central banks had eased monetary policy aggressively, taking short-term interest rates close to zero in some cases, and some were considering or implementing so-called unconventional measures to provide further stimulus. Governments were also putting in place fiscal stimulus packages. But those measures would take time to have their effect and in the short term we worried that March quarter outcomes for the global economy would be just as bad as had occurred in the December quarter. For some months, indeed, the news from abroad continued to be very poor, and global demand did contract further in the March quarter.

Given the speed of the global deterioration, we believed it would not be possible to avoid a period of weakness in the Australian economy. We thought Australia had several advantages: a sound financial system, the absence of the worst of the problems afflicting other countries, exposure to an emerging China and scope to use macroeconomic policies to cushion the downturn. The exchange rate also had declined, which would assist in adapting to weaker global conditions and lower commodity prices. So we could reasonably have expected to have had a smaller downturn than others. But it is very rare for Australia to escape completely an international downturn and it seemed quite unlikely that we could avoid one of this size completely despite the advantages that we had, for confidence here too had suffered a serious setback. That was clear in equity prices, in numerous surveys of sentiment and in the feedback that we were getting directly from businesses. We were being affected through our trade, financial and business linkages with the rest of the world.

Australia was doing better than most economies, as had been anticipated, but for a few months it was not clear how much comfort we should take from that because the economic news from abroad seemed to be so dire. As one metric of that, the IMF's forecasts for global output in 2009, when we met last February, were for growth of one-half of one per cent. That was already very weak and a much reduced forecast from just a few months earlier. Subsequently they were cut further and when released in late April showed a contraction of over one per cent in the global economy, which would be the weakest outcome for at least six decades. Forecasts for Australia were inevitably marked down as well. In fact, around the time of our May statement on monetary policy would have been, I think, the point at which the outlook for the local economy seemed to be the weakest.

In this environment, the possibility that we would need to ease monetary policy further was obviously canvassed. Financial markets expected as much, at one point pricing in a reduction in the cash rate to below two per cent. Yet the board had already aggressively eased monetary policy, delivering the largest reduction in debt servicing for indebted households in modern times. Interest rates were low or, in some cases, very low by historical standards. Substantial

fiscal stimulus was also in train. These could be expected to provide significant support for demand. So even as activity abroad continued to contract, the board had to be mindful of how much action had already been taken in anticipation of serious economic weakness. Those measures would take time to have their full effect, but that lag could not be shortened by increasing the dosage. Accordingly, while keeping open the option of further easing, the board kept a fairly steady setting through this period. There was one further small decline in the cash rate in April but, apart from that, official rates have been unchanged since we last met, in contrast to the very sharp falls which had occurred between September last year and February this year.

Where, then, do we stand at present? Things abroad hardly look rosy, but they look distinctly better than they did a few months ago. Conditions in international financial markets have continued to improve. There have been occasional reversals, but each time the improving trend has resumed. Extreme risk aversion has abated. Spreads have narrowed. Capital markets have continued to thaw—even though, in some cases, that has relied heavily on central bank financing activities. Financial institutions in the US and Europe have recorded better earnings. Global equity markets have risen by nearly 50 per cent from the lows in early March. There has been substantial new issuance of debt and equity. Spot commodity prices have picked up. In addition, it appears that the really large contractions in major countries' GDP are now behind us and that global output is levelling out. International trade and global industrial production have even recorded some gains over the past few months.

Of course, there is a long way to go and there are notable differences in economic activity across regions. While the United States and Europe only now seem to be at or near a turning point, there has already been a marked improvement in economic activity in much of East Asia and India. This reflects a few things: the significant stimulus put in place by governments in those countries, the dynamics of the inventory cycle, the healthier state of financial systems in that part of the world and, in all likelihood, just the inherently better secular growth prospects for those kinds of countries. The improvement has, as we all know, been most marked in China, but it is not confined to China. Korea, for example, which is also an important trading partner for Australia, recorded a significant bounce in GDP in the latest quarter. There are also some signs that the Japanese economy has begun to grow. In light of all that, the IMF has recently raised its outlook for growth in 2010. That forecast is actually still for pretty lacklustre growth overall; nonetheless, it is the first time in quite a while that we have seen an upward revision.

The Australian economy, meanwhile, has been resilient, with economic activity looking stronger than expected a few months ago. Both foreign and local factors have been at work. Exports have been remarkably strong. For Australia they grew over the six months to March, whereas for most countries exports declined—in many cases quite sharply—over that period. Further growth appears to have occurred in the June quarter. That reflects, of course, the strength of Chinese resource demand as well as some other factors. The strength of demand in China has also been associated with the continuation of attractive prices for many commodities. Australia's terms of trade are likely to be around 20 per cent lower this year than the peak last year, but they are still about 45 per cent higher than the 20-year average up to the year 2000.

Domestic demand, likewise, has held up pretty well, with retail sales posting quite a solid increase in the first half of this year. Demand for housing credit is up, as are house prices, and purchases of some investment goods by firms rose in midyear. Some of that strength is likely to

be temporary, as a result of fiscal measures which have a finite life. We are assuming, for example, that consumer demand and first home buyer demand for finance will be softer in the second half of the year. Nonetheless, the recent retreat from the extreme risk aversion of nine months ago, the partial recovery of household wealth and the impact of low interest rates are all likely to be supportive of demand in the period ahead.

Survey measures of business confidence have lifted from the very low levels seen at the beginning of the year to be close to or at their long-term average. Capacity utilisation on those measures has stopped its sharp decline. Business credit has been falling, but that has been more than offset by raisings of capital from other sources, direct debt raisings and equity raisings. Overall, then, business external funding has remained positive at rates similar to those seen in the 2001 slowdown.

Financial institutions, for their part, remain profitable even though they are absorbing higher loan impairments. Business investment has been an area of expected weakness in forecasts for the economy. I think that is still likely to be true, though some recent liaisons suggest that some firms may be rethinking the size of the cuts to investment spending.

Differences across sectors remain, of course, as they usually do. The commercial property sector, for example, is partway through a difficult period of adjustment to valuation and leverage, even as parts of the mining sector are back to producing at full tilt to supply the Chinese demand for resources.

The labour market has seen considerably softer conditions, but there has been little decline yet in overall employment, and the rise in unemployment to date looks smaller than had been feared just a few months ago. Several commentators have pointed out that there has been a significant fall in hours worked, as there usually is in downturns. That may be a more reliable gauge of the extent of labour market weakening than employment or unemployment. Compared with earlier cycles, the reduction in hours on this occasion has occurred, it seems, via a reduction in hours across a broader range of people rather than being concentrated in a smaller number of unemployed.

At this point, the fall in hours worked looks larger than what occurred in 2001 but not as large as in 1991. In fact, I would say that is probably at this point a reasonable characterisation of this downturn in general. That is, on the basis of the information we have at the moment, this may well turn out to be one of the shallower recessions Australia has experienced.

Inflation, meanwhile, has been easing. CPI inflation recorded its lowest outcome in a decade—about 1½ per cent in the June quarter. That compares with a peak of about five per cent in September last year. The size of that decline overstates the real extent of the slowing in prices, just as the peak figure a year ago overstated the real extent of inflation. Measures of underlying inflation remain higher, at about 3¾ per cent, but they too are gradually declining. We believe that decline has further to go, though in the medium term, on either a CPI or underlying basis, inflation looks like it will not fall as far as we thought a few months ago.

Looking ahead, as I noted earlier, some of the recent strength in private demand might prove to be temporary. At the same time, though, the contribution of public spending to growth in demand is likely to increase in the year ahead. More generally, there has been enough genuine

strength in the run of recent indicators, sufficient further improvement in financial conditions and enough recovery in sentiment that forecasters are starting to lift their numbers for overall growth in 2009 and 2010. That is for Australia.

As always, of course, there are risks. The global economy could suffer another setback of some kind. We think the likelihood of that has declined, but the possibility nonetheless remains. Perhaps the growth in China's demand will falter. Certainly the pace of China's growth in the June quarter, which was extraordinary, cannot keep going for very long and it may well be moderating now. We need, of course, to keep in mind or keep an eye out for potential imbalances in China. Having said that, though, sceptics about the growth of China so far, I think, may have underestimated the determination of Chinese policymakers to grow their economy and I doubt that determination has lessened.

Some of the pick-up in global industrial output is clearly due to the cessation of inventory rundown, and so prospects for final demand will actually prove to be the most important thing in determining the pace of future growth. On that score, the process of balance sheet consolidation for both private and public sectors in some major countries will probably weigh on growth in demand there for some time. I am not talking about Australia there; I am talking about major economies elsewhere. So that is something that might weigh on demand globally.

On the other hand, performances of both Australia and some of our key partners have exceeded expectations in the recent past. That could continue, particularly if rising confidence were to feed to further demand thus increasing income and so on. That, after all, is how most recoveries proceed. It certainly is in cases where there is no strong headwind at work from a financial restructuring.

Moreover, just as the severity and the simultaneity of the global downturn was unprecedented, so was the speed and the strength of the policy response around the world. Six months ago, the possibility that concerted global policy action might deliver a surprise on the upside for growth was noted, though it seemed maybe a little bit theoretical at that time. I think it is a bit easier to imagine that possibility now than it was then.

The forecasts outlined in our recent statement on monetary policy give our best assessment of the most likely outcomes for Australia, contingent on the factors I have mentioned and various others. Of course, considerable uncertainty surrounds those numbers. Nonetheless, if things continue to look like they will turn out in that fashion, there will come a time when the exceptional monetary stimulus in place at present will no longer be needed. It will then be appropriate for the board to do what it has done on past such occasions—namely, to start adjusting interest rates back towards normal levels. The timing and pace of those adjustments, if and when they come, will of course be a matter of careful consideration, taking into account all the relevant factors, including what might be happening with market interest rates at the time.

Last time we met I said that I thought there were reasonable grounds to think that the Australian economy would come through this difficult episode as well placed as any to benefit from future expansion. That remains my view. The economy appears to be weathering a very large storm quite well, and the community's confidence about the future has commensurately improved. No doubt that future will pose its own challenges, but I think we are well placed to meet them. My colleagues and I look forward to your questions. Thank you.

CHAIR—Thank you, Governor. Before we move on, would a committee member please move that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication? So moved by Mr Briggs. We will now go to questions. Committee members: I would like to continue today with the practice I have adopted in the past. If there are questions that arise from questions that come from another committee member, please indicate that you want to flow on from that so that we can try to deal with questions thematically and not just chronologically.

Mr Stevens, I would like to kick this off by going to the second last paragraph of your statement where you talked about the exceptional monetary stimulus in place at the present and that there will be a time when adjustments need to be made to monetary policy. We saw a 0.4 per cent growth in the last quarter. Can you give us your view on how you think the next two quarters will go and a better idea, should those adjustments be needed, of what sort of timing you are thinking about at this particular stage.

Mr Stevens—On the next couple of quarters, the statement we issued after the last board meeting said that we thought in the near term the most likely outcome was for sluggish output—that is, not a lot of growth. It is in fact even possible that we will get another quarterly contraction sometime in the next couple of quarters. That is the judgment we have reached, and that is consistent with the figures which lay behind the forecasts in the statement.

So, as I said in the opening presentation, it is possible that some of the strength we have seen in some areas of household spending will lessen in the near term because some of that strength has probably been because of the various fiscal things which were designed to be temporary and were temporary and their effect will pass as time goes on. Of course, other measures are starting to speed up and they will take over. Without wanting to go into fine detail of quarterly point forecasts, which I think you have got to make but there is a high margin of uncertainty around them, so it does not pay, I do not think, to dwell on them in great detail, but they are for pretty sluggish output in the June quarter and the September quarter. We have said all along that we felt the prospects for a recovery getting going towards the end of the year were good. I think they are still good, probably better than they were, and growth will start to pick up during 2010.

On the timing of when we might adjust policy, that is an issue about which one keeps an open mind at this point, obviously. The point simply is that when we reach the point of judging that this exceptional degree of stimulus is not needed, it will be the right thing to do to start removing it before it is excessive for too long. Exactly when that begins, you will not be surprised to hear me remain a little coy about—people are getting very excited out there and it is not my job to add to the excitement, I do not think—but in a timely fashion when the time is right is the answer.

CHAIR—In terms of an effort to dampen down some of that enthusiasm that might be there, from the answer you have just given you are not seeing in the next six months some need at this stage to look at tightening monetary policy?

Mr Stevens—I did not say that. In six months a fair bit can happen. Financial markets are pricing higher interest rates starting to begin towards the end of the year. Now, I do not have any comment to make about that today. I am not here to dissuade them and certainly not here to encourage them either. I just note that markets around the world actually are pricing in the

forward curve some lift in overnight rates in most countries during 2010, including Australia, and they have us starting a little earlier than some others, which I guess as a broad proposition maybe is not that unusual because our economy is a fair bit stronger than most others. But I do not want to give any particular steer on timing today.

CHAIR—Let me try and follow that from a slightly different direction, then. You made some comments about the reduction in hours that people are working. Fujitsu released a survey, I think today, talking about the effects that that is having on the capacity for households to repay their mortgages. We still have unemployment and I think you are forecasting unemployment to continue to rise at the moment. How heavily does that weigh in terms of the decisions that you would take in terms of tightening monetary policy, given the actual effect it will have on demand in the real economy?

Mr Stevens—Obviously those things are important, but let me make a couple of points about household debt servicing and so on. Firstly, the fall in the servicing burden we have had in the last nine months is a larger and faster fall than we have ever had before in such a period. Secondly, arrears rates on mortgages have been tending to rise over the past year, as they were always going to when the economy slowed, but they remain quite low by either our own past standards or certainly by the standards of almost any other country. In fact, in some portfolios arrears rates in the past few months have actually come down.

That is not surprising, because interest rates have come down. I think we would have to say that more people remain in jobs today than most of us thought would be the case six months ago and they are paying lower interest rates. So, not surprisingly, the capacity to keep servicing those loans has actually remained quite good. I think there has tended to be, I would have to say, over the last couple of years, in some quarters perhaps more concerned about mortgage servicing ability than really was warranted. It is certainly an important question, but we felt all along that households would probably cope pretty well with servicing the debt they had, and so far I think they have coped pretty well.

The decline in hours versus unemployment actually helps this, I think, because I do not think there is much doubt that the single biggest problem that people would have in servicing a loan obligation of any kind is going to be if they lose their job. If their hours are reduced and the income is reduced but there is still an income coming, that is a much better situation than the loss of the income. So I would hazard a guess that the apparent phenomenon we have here where the reduction in hours of work is spread more evenly across the workforce rather than concentrated in the unemployed, relative at least to other cycles, that will help I think this debt servicing question rather than hinder it. So I think that, basically, households have continued to be able to service debt pretty well in the vast bulk of cases. It has actually gotten much easier for many of them because of much lower rates in recent times. Yes, of course, when the time comes for interest rates to start rising, we will keep all that in mind, but I think the economy is actually in pretty good shape in that dimension at this point—and a fair bit better shape than many people would have feared.

CHAIR—To follow on again, as you are looking behind the headline unemployment figures, looking at the reduction in hours in making decisions on monetary policy, I am sure you are examining particular areas of the economy that may be suffering in terms of the downturn more than most. For example, on the Central Coast of New South Wales, we have youth

unemployment in excess of 40 per cent. Clearly concerns about tightening monetary policy and its effect on youth unemployment must be something that you would consider in terms of tightening monetary policy?

Mr Stevens—Sure. I would imagine not many of those youths actually have a mortgage, because they, presumably, have not got much income with which to service it.

CHAIR—They do not have a job either is the point.

Mr Stevens—Sure, all those things are important but, as we have said previously on issues of sectoral differences, in the end we have got to make policy for the aggregate, bearing in mind those sectoral differences and attuning to them as best we can. But in the end it is the aggregate that we have to pay the highest regard to. That is the way it is.

CHAIR—I accept that. The reason it was raised was that you were going behind the aggregate rates of unemployment to look at the change in hours. I think it is equally valid to look at chronic unemployment for our youth and the effect that tightening monetary policy will have on their employment prospects.

Mr Stevens—Whether it turns out to be chronic unemployment—that is, long lived—will hinge mostly—The best way to prevent that is going to be a growing economy, a flexible set of labour arrangements and an economy that is well in balance. Our job is to try to play our part in keeping that balance, which, at the moment, of course, means interest rates are unusually low. But if we keep them low too long then we will get imbalances that will not help the chronic unemployment potential for those people. So the best we are going to be able to do is a recovering economy on a balanced growth path. That is what we are aiming to achieve.

CHAIR—I know Mr Bradbury wants to jump in but just before he does I have one more question in terms of this area in particular. Your statement today says that in relation to inflation you are seeing that there will continue to be a decline. Given that inflation appears to be well within your target range and you are looking at it continuing to decline and given that you are looking at unemployment continuing to increase, would you agree with me that these are certainly not the circumstances right now in which to be looking at tightening monetary policy?

Mr Stevens—Well, we are not tightening monetary policy right now. To give a bit of perspective to this discussion about when the time will come for interest rates to lift off the bottom, what we have got in place at the moment is an emergency setting. It is a setting of the cash rate that is the lowest for 40 years put in place in anticipation that the economy would be seriously weak and that there would be very real risks to the downside that stem from a global situation that none of us has lived through before. I think it was appropriate to react in the aggressive way that we did to that forecast and that set of risks. As the set of risks that you think you face start to shift, at some point you are going to have to make a response to move away from the emergency setting. That is really what I am saying.

That in no way signals any less concern for these other economic dimensions. When the time comes it will mainly be that the emergency has passed sufficiently so that we do not hold the emergency setting any longer. Were we to do so, I think that there is ample evidence elsewhere in the world of problems that you ultimately get if you keep the emergency setting in place for

too long. This, by the way, is something that applies at either end of the cycle. You do not keep the peak rates in place for a very long time either, for similar sorts of considerations. So the point is we, the world, have lived through a set of financial events and then a set of real economy events in most countries—happily not in this one—over the past year that have been extraordinary. Extraordinary measures were taken to address those. That was right, but when the emergency has passed you have got to then think about withdrawing the emergency measures over time. When the time comes that is what we will be thinking of doing. When that is and the pace at which that is done are of course yet to be decided.

CHAIR—Mr Bradbury had a follow-up question.

Mr BRADBURY—Thanks, Chair. I just wanted to pick up on this point in relation to the reduction in overall hours worked as an indicator that might tell us a little bit about more than just unemployment figures per se. I am pleased to see that you are looking at these figures. One of the issues that I wish to just note in relation to that point is that clearly for many households if there is a reduction in overall hours then, whilst there have been significant reductions in interest rates, their ability to continue to pay their mortgage repayments will have been affected by that overall reduction in hours. So I would assume that in heading forward the Reserve Bank would take into account the fact that many households, as a result of that overall reduction in hours, will be more sensitive to movements in monetary policy and that those factors would be taken into account as decisions were to be made in the future.

Mr Stevens—That is right, Mr Bradbury—absolutely. Let me make one additional point. I am not going to be able to make it from a chart in the statement, by the look of it. But you can measure, at an aggregate level, what has happened to the debt servicing burden as a share of income, which of course has got in it the fact that hours have declined. I am looking at the chart here—you cannot see it—and the debt servicing burden for mortgages has fallen by four percentage points of income, basically since the middle of last year. That, if I remember rightly, is probably a bigger reduction in that debt servicing component than we had in the early 1990s, and it has been delivered much faster—two or three times quicker. So it is true, as you say, that a reduction in hours is a reduction in income relative to the counterfactual for those households. But I think the big fact here is that the debt servicing burden relative to total income, which is what we are measuring here—and that has got in it the reduction in hours, along with wages and all the other things—has fallen very sharply. It has fallen faster and further than we have seen before in Australia's modern economic history. I personally think that has played quite a big role in supporting the ability of households both to service loans and to consume. That has been a very important factor.

CHAIR—Mr Morrison has a follow-up question.

Mr MORRISON—Thank you. It is always good to be meeting a constituent at a hearing, Governor.

Mr Stevens—Your predecessor was the chairman, so it is a common experience.

Mr MORRISON—Yes, it is a Shire conspiracy! Governor, I wanted to tease out further these points you have been making about moving away from an emergency setting—if I have quoted you correctly—and really explore this idea that at some point we have to move off the sugar diet

onto a protein diet with our economy. I note that in the August statement there is an indication, or a suggestion, that at some point monetary policy will obviously have to be tightened. It is more likely to go that way than the other, I suppose is a fairer way to assess it. I also note that the Treasurer has talked about the need for fiscal and monetary policies to work together. Given that we have an improved outlook going forward, based on your assessment, than we were contemplating in, say, October or November last year, or February this year, and given the risk also of stimulus projects that were really announced purely on the basis of their stimulus merits and the prospect of some of those projects being unable to meet stimulus timetables, at what point, by pursuing those projects when they are falling behind timetable, do we risk over-stimulation? What risks of over-stimulation are there for inflationary impacts in the economy and for what the Reserve Bank might have to do to correct any inflationary impacts of over-stimulating the economy by effectively allowing the stimulus to go past its use-by date?

Mr Stevens—Let me try to be clear to begin with, in answering that question, that the forecasts we have, and which are in the document, embody the assumption that the various fiscal plans that have been announced to date proceed. They do, to be fair to your question, also assume that there is not a very large-scale delay. Were there to be a delay, that probably at the margin would lower the forecast for demand in the near term—and then, if the project eventually still proceeded, would obviously raise it further out.

At the present time I do not think we are in the position of feeling that we are going to get serious problems of imbalances arising from those delays thus far. That could change if there were to be much bigger delays, of course, but at this point the various stimulus things that have been announced over the past year are built into the numbers we put out. I do not think you would say that those figures are delivering the message that there is somehow too much growth in the economy, at least in the near term. At the end of the forecast period, growth is, as we have it in our forecast, above trend, but that is somewhat out. And, of course, you want to grow above trend in a recovery at some stage. That is part of what a recovery involves.

We are not saying here, on what we know today at least, that there is too much growth. If someone wanted to make the argument that there is a need for more fiscal stimulus from here, I do not think I would agree with that, based on the outlook as we see it, anyway. The figures we have and the view we have taken embody the measures that have been announced and assume that they take place in a reasonably timely fashion and we are comfortable enough with that at this point in time.

Mr MORRISON—At some point, does increasing debt to pay for stimulus become counterproductive?

Mr Stevens—It depends how much debt there is. I think that the sort of federal debt we are going to see, if the projections in the budget papers turn out to be right, will be that net debt is going to go from about minus five per cent of GDP and, according to the budget figures, peak at less than 15 per cent. That is a significant change, but 15 per cent of GDP is a low number by virtually any other standard. So I do not feel that that debt burden, if that is what happens, is going to seriously impair the country's economy. It will require, and the government has acknowledged this, a lot of discipline on spending over not the immediate years but the years into the future to make these projections come to pass. That has been acknowledged, but for the debt per se, I do not think you can really say that net debt of 15 per cent of GDP itself is a

serious problem. If the rate at which it is increasing kept going for many years, at some point that would be a problem, but provided that it does not, I do not think you can say it is a serious problem.

Mr MORRISON—What do you put down to the level of debt in Australia being so relatively? What do you think is the principle reason that debt is so low?

Mr Stevens—I would say that is basically pretty conservative fiscal policy for quite a long time. Also, privatisations in the 1990s took out quite a bit of the debt that was in existence then. The privatisation of Telstra reduced debt a lot but, by and large, for probably 20 years we have had, on the whole, pretty conservative fiscal policy in this country by the standards of others. That is the legacy. It is that legacy that has made the room for fiscal policy to do what it did in the downturn—that is, move to expansion—just as prudent monetary policy for a long time meant that we had scope to cut interest rates credibly and help the economy. You earn that scope on both monetary and fiscal policy by many previous years of careful management.

CHAIR—Following that line of questioning, Governor, the last time you were before us you made some comments about the size of the stimulus. To paraphrase, you said words to the effect that it did not strike you as being excessive. Have you changed your view in any sense since the last hearing in relation to the stimulus?

Mr Stevens—I think there was a bit more stimulus after that hearing. I suppose the question is how you decide whether something was too much, not enough or roughly right. You could do that in a few ways. One way would be to look at the economic outcomes. The episode is not finished, so we cannot do this in a definitive way yet. We will not be able to for a year or two. Thus far, one would say that the economy, as far as I can see, is not in a really deep recession, which I think says that whatever stimulus was given was not obviously too little. I think we have still had a downturn. It is not *prima facie* clear either that there was too much. Obviously, the monetary stimulus was correct. I am here to defend that proposition. At this point in time, I am not terribly worried that there was too much fiscal, provided that the path we are talking about into the future is stuck too. Obviously the government will need to stick to that and, at a certain point in time, that will not be easy, but they know that. They have already said that.

CHAIR—In terms of the fiscal stimulus, compared to other countries around the world, where does the Australian stimulus fit?

Mr Stevens—It is probably one of the more aggressive ones. It was very quick. It was substantial in size and reasonably persistent in time—that is, across a couple of years. You could point to other countries. China would be the main one that I could think of where the stimulus was bigger and, quite clearly, it has had quite a big impact in that country, which is having a significant impact on Australia. I do not think we are at the smaller end of fiscal. We are not at the top either. It was substantial and quickly done, but that has been one of the things that has helped support the economy. Like the monetary stimulus at the right time, this has to be allowed to unwind.

CHAIR—So the size and the speed of the stimulus package assisted in Australia's comparatively good position in the world?

Mr Stevens—You have to conclude that that is probably right. I am uncomfortable defending fiscal policies. It is not my job to defend it—that is the government’s job—but I think an objective observer would say that the size and speed of that response has been one of the important factors in supporting private demand over the past nine months.

Mr MORRISON—Given the statement you just made, going back to, say, October or November last year, and again February this year, when there was a much more pessimistic view being purported officially, do you think there was sufficient weight given to the comparative strength of the Australian economy going into this global crisis and in framing policy settings? As you have acknowledged in your own report, it was one of the key factors that emerged so strongly and we had, as you said, one of the most aggressive stimulus packages anywhere in the world. Was the weight of that, compared to the relative strength of the economy going into this, consistent?

Mr Stevens—We certainly, ourselves, gave very great weight to the comparative strengths of the economy. We were saying all along, ‘We’ll do better than other countries; we don’t have the financial problems; we’ve got a strong financial system,’ et cetera. I have probably been accused by some people of being a bit panglossian in my attempts to try to hold confidence. Late last year, I was giving speech after speech saying: ‘We’re going to be okay. It’s going to be hard but we can get through. Don’t lose confidence.’ That was on the basis that I think the country has very strong long-run fundamentals. We have the odd problem, for sure, but this was a country about which you could have a fair degree of well-based confidence, and I thought it was important to say that. So, at least for our part, I think we did have a good appreciation of the economy’s fundamental strengths.

Nonetheless, I think it was appropriate for us to do what we did with monetary policy, which was, of course, quite aggressive. The first of the really big rate cuts in the world was by us, actually. If you see a serious risk situation coming, I think you have two obligations: one, to try to help people understand it and try to sustain confidence, but also, in our case, I think, to use prudently the tools and the scope we had to give support as well. So we did that, and I think that was the right thing to do.

Mr MORRISON—Do you think then, perhaps, over the balance at the back end of last year and the beginning of this year, there was, frankly, a bit too much pessimism—that statements were probably a bit too strong, given the relative strength of the Australian economy? I am not talking about your comments.

Mr Stevens—I will stand by everything we said. I think it was judged carefully and finely balanced. As for what other people said, it is really for them to defend.

Mr BRIGGS—Governor, out of interest: in your opening statement in the August *Statement on monetary policy*, you talk about, at some point, cash rates returning to normal levels.

Mr Stevens—Towards normal.

Mr BRIGGS—Towards normal levels. What is a normal level? What would you define as the normal level?

Mr Stevens—I thought that might be question 1 rather than question 2 today. It is an obvious question.

Mr BRIGGS—It's a dorothy! I organised it!

Mr Stevens—It is a question to which I want to be careful not to give too specific an answer, and there is a reason for that. I think, pretty clearly, 'normal' is a good deal north of where the cash rate is now. For the past going on towards 20 years, probably 17 or 18 years—that is, in the low-inflation world that we have been in since the early nineties—the average cash rate is in the fives, I think. Am I right there? Now, I do not want to endorse a particular number because then I think we trigger all sorts of excitement out there about exactly what the slope is going to be to that figure and by when. We should not have a dogmatic opinion about exactly where this so-called 'normal' is because, for a start, it is not necessarily a constant, and we have to take into account as well the possibility that the rates that borrowers and lenders actually pay or receive, relative to the rate we set, can move—and they have moved, as you know, in the past year. In the past several years before that, they were actually moving the other way relative to the cash rate. So, for all those reasons, I am a bit wary of nominating a particular number, but—

Mr BRIGGS—Historic evidence suggests somewhere in the fives?

Mr Stevens—it is higher than three, and it is probably noticeably higher than three. How soon we get to that—

Mr BRIGGS—Back on the labour market conditions and the hours of work versus unemployment rates and so forth, I am interested in your view on the comparison between this downturn and the one of the early 1990s. You said earlier that you thought that it looked like we are getting through this in better condition and that it is not as deep as it was in the early 1990s. What weight do you give to the deregulation of the labour market in helping us get through this turn compared to that of the early 1990s and particularly the fact that employers have been given the opportunity to keep staff on—with reduced hours and so forth but keeping their job? I am interested in your views on that.

Mr Stevens—By anybody's reckoning, the arrangements in the labour market that we have today—and it is not just the black letter law legal arrangements, but also the whole set of attitudes on the part of all the participants—are different to the bad old days. Even by the early 1990s, there had been a fair amount of change in that direction. What I would also say is that I think that this generally more flexible set of arrangements overall was helping in the boom, too. We have talked about this at this committee before. We were seeing quite a bit of change in relative wages by industry and by region. Given that some of the shocks that the economy was facing had geographic differences in where they hit and industry differences, exactly what the textbook would tell you should happen, which is that the relative prices will adjust to induce the labour resources and the capital resources to flow, did happen. Overall, growth in labour costs was, one would have to say, fairly well behaved, given how tight the overall labour market was before the downturn began. All these things have been helpful. I am sure that your next question will be whether recent changes are going to undo all that. Time will tell, but—

Mr BRIGGS—It was not, actually.

Mr Stevens—Someone is going to ask that. They usually do.

Mr BRIGGS—I suspect what you would say on—

Mr Stevens—Generally, the set of arrangements that we have had in place in recent years has resulted from a lot of reform over a long period that have made this all work better. We see the advantages of that. Ultimately, labour market arrangements are about where the sustainable unemployment rate is.

Mr BRIGGS—Supply. I have one very short follow-up question.

CHAIR—The last question was not really a follow-up question at all; it was a new area. I am sure at some stage the coalition members will not disappoint and will ask another question about Work Choices, as they have every hearing so far. Is your question genuinely a follow-up question?

Mr BRIGGS—It is question about labour market issues.

CHAIR—We will come to the labour market as we go through.

Mr BRIGGS—David was asking questions about the labour market earlier, Craig.

CHAIR—We will move on. There are a couple more follow-up questions.

Mr FITZGIBBON—I am not sure whether my question is a follow-up question. I will give it a go and see where it takes us.

Mr BRIGGS—You will probably get treated better, Joel, I suspect.

Mr FITZGIBBON—In response to Mr Briggs' attempt at least to pin this on changes in the labour market, I found your comments in the statement on monetary policy quite reassuring on that front. The chairman and Mr Bradbury spent some time urging you, I suppose, by way of questioning to give more weight or more thought to the lag indicator of unemployment in your future deliberations. But you rightly pointed out that in your future deliberations you will have a mind to ensuring that we do not have developing imbalances in aggregate supply and demand and all the implications from such an imbalance for inflation. What do you see as the greatest threats in terms of keeping that balance in the future and therefore the future threats to inflation? Where are the main threats coming from?

Mr Stevens—Usually people think about goods and services inflation as demand versus supply as one element, and then there are expectations which give the inertial property to inflation. If we all expect inflation to continue, we behave accordingly and that helps it happen.

A year ago one of the concerns we had was that expectations of inflation looked like they were starting to edge higher. We do not actually have very good gauges of long-term inflation expectations of households; we have a 'one year ahead' thing and it was rising because they correctly saw petrol prices had gone up and that does push up inflation temporarily. But in that situation where the economy is booming, inflation is high and inflation expectations are starting

to rise, that is obviously troubling and it is very important to keep those expectations anchored at a low level, which is part of the reason for having an inflation target, as we do. And happily for the most part I think, those expectations have subsided and are back consistent generally with where the target is. So that is good. I think the system here has sufficient credibility generally that expectations are likely to stay well anchored. That is the thing we watch, but I do not think that it is threatening just now. In some other countries of course they have been worried that expectations of deflation would take root and that would give them a very serious problem. But that has not been a problem for us.

On the excess demand versus supply side, clearly capacity usage has come down quite noticeably. It is not really low at this point and it seems to be levelling out. But there is more spare capacity in the economy now than there was and that is part of the story that we are telling in our statement for why we think inflation will continue gradually to subside for a little while yet. So I think those things are okay.

We would get more worried about goods and services inflation I think if we saw that demand growth was starting to exceed our expectations persistently. Potentially that could call into question the forecast that inflation keeps falling for another year and a half, and obviously that would be quite important if we saw evidence for that picture starting to emerge. But at the present time the outlook that we have here is that there is enough in train for inflation pressures to keep gradually subsiding over the period ahead.

The CPI is going to be a difficult gauge to use in a sense, because it is artificially held down by the big fall in petrol, which is going to pass out and then the CPI inflation will go back up. So we are roughly where core is so we have got a communication issue which we will have to help explain that to people when the time comes. So I think those things are okay. I think that we need to keep an eye out for other potential imbalances that could emerge but so far I think that we are travelling okay on those fronts.

Mr FITZGIBBON—Do you have any concerns about the ABS methodology for forecasting underlying core inflation?

Mr Stevens—The measure of core inflation that we use is actually one we created, so if there is a problem with that I do not think that we could blame the bureau; we would have to accept responsibility. As you probably will recall, there have been a number of measures of so-called underlying inflation that we have tracked over the years, and we continue to compute them. The bureau very helpfully compiles those on the day so that everybody gets them at the same release time, and I think that that has been a good step forward.

So I do not have any sort of particular criticisms to offer about the measure of underlying inflation—the various measures that my own staff have created—at this point. There are one or two things in the CPI that I think are methodologically difficult. It is difficult for anyone; it is not a criticism of the bureau—but the thing that is in there for interest margins moves quite a bit and that is, I think, proving difficult to predict for many people. But there are always some things like that.

Mr BRADBURY—I just want to pick up on the issue that Mr Briggs raised in relation to the return to more normal rates of interest. I can understand your, I guess, lack of willingness to try

to set out specific figures that you may later be held to, and I appreciate that. But can I approach the issue from a slightly different perspective—that is, right across communities throughout this country there are many people who might be intending to embark upon buying their first home. Certainly for many people in my community I see that, because of some of the incentives that are available, that is a possibility for them. What can you say to those people within our community who might be thinking about buying their first home but who are also concerned that they provide sufficient leeway and ability to meet any increase in debt-servicing costs into the future? I do not expect you to give them a figure as to how much they should factor in but what can you say to those people across the country?

Mr Stevens—I think I would say to anybody who is contemplating taking on a variable rate obligation that interest rates could always rise and you should always allow some capacity to cope with that—and, indeed, the lender should be testing your capacity to cope with that before they give you a loan; that is what they are supposed to do. It used to be the practice, I thought, that certainly the banks would test whether the borrower could cope with a two percentage point increase. I do not know if they still apply that particular test, and I am not endorsing two percentage points as the relevant metric, but, generally speaking, lenders should be applying that test because it is only prudent at any time.

I think everybody knows that interest rates right at the moment are unusually low. I think everybody understands why that is, and everybody also understands that they will not stay that low indefinitely. So everybody knows that they should keep in mind the possibility and the likelihood that at some point the rates will be somewhat higher—at least on variable rate loans, because fixed-rate loans have already gone up to some extent because the yield curves are already building in some of these increases. I do not offer financial advice to people but it would always be prudent to be confident you could absorb some increase in interest rates when you are taking out a variable rate loan at any time, particularly now but probably at any time.

Mr BRADBURY—I would like to just pick up on the issue that was previously raised in relation to the effectiveness or otherwise of fiscal policy. Clearly when we last met back in February the situation was looking a lot more dire than it is being portrayed in your statement today, and much has happened in that time. Part of that has been as a result of coordinated fiscal and monetary policy responses. Can we have a look at some of the particular measures that have been implemented, particularly in terms of the cash and transfer payments that were made since we last met with you—and also business and investment allowances and, in addition to that, the first home owners boost. Are you able to make any specific observations in terms of what impacts some of those measures have had on supporting demand and supporting jobs within the economy?

Mr Stevens—I think it is clear that the cash transfers have had some impact on retail sales. It is pretty clear that certain things you would look at—for example, sales of motor vehicles to companies—spiked very sharply in June, which we assume is largely a result of that additional allowance. It is clear that the first home owners have been, until recently, very prominent in the pick-up in demand for housing finance. That is generalising further now and the first home buyers are starting to tail off, but those things have had effects. Phil, do you want to add any specific detail to those remarks?

Dr Lowe—On the cash payments in our analysis we have assumed that around half of that has been spent within six months. The data we have seen is broadly consistent with that. In the months in which the payments were made, you see a very large increase in retail spending but you also see quite a large increase in debt repayments in those months. So it is clear, particularly in the credit card data, that people have taken some of those payments and paid down their credit cards. You can also see in the housing finance data that some people have taken at least some part of the \$900 and paid down their mortgage. If you look at the surveys that have been done where they ask people, ‘How much of this money has been spent?’, broadly around half of the people say they have spent either all of it or most of it. So I think the sense that around half of it has been spent within a six-month period is right. In terms of the tax deductions for plant and equipment investment, as Glenn said, you do see a very big increase in car sales in the month of June. I think that was largely a result of that tax subsidy. In our liaison, we also hear businesses telling us that there was quite a lot of demand for plant and equipment in the month of June, particularly as large businesses tried to take advantage of that. So it has clearly had an effect and, as Glenn mentioned in his opening remarks, the issue is how durable the effect is going to be.

CHAIR—As we are getting close to the break, one of our students from Fort Street High School has a question for you.

Sangay Charali—Would the governor please provide an insight into the board’s monetary policy deliberations in regard to distortions that occur in aggregate measures due to regional growth variations such as what we witnessed in the recent commodities boom?

Mr Stevens—I am not sure I would call those effects ‘distortions’. They are impacts on different parts of the economy that are varying across both the regions geographically and across industries. We have quite an active program of business liaison that goes all around the country and that is all compiled in the state offices and fed into the economic analysis that the people in Phil’s area do each month. The board periodically gets a paper which displays the different regional and industry differences across the economy for their information. So I think with that and also the fact that the board members themselves come from other states—one comes from Perth—they get around the country quite a bit in their own careers and in the work they do. I think they have a pretty reasonable handle on the extent to which the various things that are happening in the global economy have a differing impact in various regions in Australia.

CHAIR—We also have a question from Ms Neffati from Domremy College.

Aicha Neffati—We are all concerned about economic growth, yet economic growth has serious environmental costs. Do you see a time when the way the national accounts are measured is changed to include the damage of our natural assets? Our history of economic growth appears less impressive when we subtract the environmental degradation that has occurred due to our obsession with continuous growth.

Mr Stevens—I can imagine a world in which there are accounts drawn up for those sorts of things. I am not sure it will be easy to do, but it will not be me who has the task of doing it, fortunately! I would make one other point, which is that it is the countries who today are most affluent materially who are in a position to care most about the environment, the physical environment, that they live in, and it is by and large, I would say, the poorest countries who cannot afford to look after their environment. So you are right that a narrow focus on growth

does do damage to the environment, but I think I would add that the countries that have become the most economically advanced and affluent are the ones who are in the best position to actually preserve the environment in the future.

Aicha Neffati—Thank you.

CHAIR—That was a great question. We should have had you in the Senate yesterday, I think! Given the time it is now, we will have a short break.

Proceedings suspended from 10.46 am to 11.05 am

CHAIR—We will resume the hearing. I will go to questions from Mr Morrison.

Mr MORRISON—Governor, can I take you to your speech to the Anika Foundation, where you said:

A very real challenge in the near term is the following: how to ensure that the ready availability and low cost of housing finance is translated into more dwellings, not just higher prices.

And later:

... this ought to be the time when we can add to the dwelling stock without a major run-up in prices. If we fail to do that—if all we end up with is higher prices and not many more dwellings—then it will be very disappointing, indeed quite disturbing.

Given that house prices have risen by about four per cent per annum since 2003, and below nominal GDP growth, I wonder if you could give some clarity to this issue of whether you believe that right now Australia is experiencing a housing bubble.

Mr Stevens—I never used the word ‘bubble’ in that talk. I notice it has been freely used by various other people who have reported the speech. But I think that if I were asked, ‘Is what we see right now a bubble?’ in the normal sense of that word—that is, that there is a highly speculative mentality: a very rapid credit growth gearing up, seeking only the expectation of a short-term gain—then I am not sure that I would describe what we see right at the moment in quite those terms. That is not to say that the level of prices is not still pretty high.

I think the background here is that, relative to mean income, dwelling prices have actually declined since about the end of 2003—not in a straight line, but basically they have come down a bit. And they were, of course, rather unusually high at that time. In an earlier speech I said that I thought that showed that you could have an adjustment here in a way that was not really disruptive—unlike some of the other adjustments we are seeing in other countries. But, nonetheless, I think prices remain high. For a country of our physical size and with the population we have, it still strikes me as a little bit hard to explain why the price of dwellings here is towards the upper end of what you see internationally. I do not have an adequate explanation, really, to offer for that, but it strikes me that that is an issue. I think we have had various partial explanations of it over the years. But it would be worrying, wouldn't it?

The point I was making in the talk was that, at the moment, big-ticket construction is slowing down for various reasons that we are all familiar with. A couple of years ago it was booming and the housing part was being held back by high interest rates, among other things, to make room. We do not need to do that now. This is the time when we can build more houses, and the population dynamics are such that we should be building more, I think. The physical resources are more available to do it now. The financial resources are there for the end buyers at least—interest rates are low, credit is available for home buyers. This ought to be a moment when we can get some new stock built, hopefully without too much of a run-up in the prices of existing homes. That is the point I was making. I think it would be disappointing if we cannot manage that.

Mr MORRISON—Governor, I would agree that it would be very disappointing. The first home owners grant boost—something the coalition supported at the time—will be wound back. It will be wound back over the back half of this year. Also, in our discussion this morning—I am not asking you to comment on this—there was a perception that, at this point in the cycle, rates are more likely to rise than fall. To tease out the issue of what is going on in the housing market, what do you believe is more likely to drive and underpin prices? In particular, do you think that there are serious supply bottlenecks in place in the housing market—whether those issues relate to land supply, planning, taxes and charges or any of the things that are more fundamentally the reason why we have such pressure on house prices in this country? Do you think that is something that needs to be addressed so we do not get to the more disturbing outcome?

Mr Stevens—I am not an expert in the fine detail of zoning laws and those things, but I think it is demonstrably true that, certainly in this city, the price of a marginal block of land is quite high—on some figures, a couple of hundred thousand dollars a block. There are levies and so on that contribute to that. There may well be good reason to have those various charges from a community point of view, but I suppose what I am saying is that we ought to be prepared to examine the question of whether we have managed to make the supply price of the marginal dwelling higher than it really needs to be. Those are important things. There is probably also, unfortunately, some finance constraint just now—that is, developers are finding it much more difficult to get funding. You have to have sold more pre-sales at a lower price, a lower LVR and so on. Some of the financial institutions which, a couple of years back, were more aggressive in this area have probably been amongst the ones that have tightened up the most. That reason as well could be why, at least for a little while, it will be hard to get additional supply. I suspect that that constraint will in due course begin to ease, because at some point the perceived riskiness of these developments will start to lessen as it becomes clear that the underlying demand is there. What we hope is that the process of getting to that equilibrium does not involve a very large increase in prices across the board—not so much because that is a bubble, per se, but just because I think the cost of the marginal unit of housing is an important social issue.

Mr MORRISON—I agree. Regarding the question about the issue of a bubble, I suppose that type of perception would lead many banks, many financiers, to be very concerned about extending credit to the sector. Do you think it is fair to say that, whether it is the issue of taxes and charges or rising building costs, planning issues—whatever those issues are that largely relate to supply—instead of facing a housing bubble we are really faced with a housing bottleneck, and that the result of that bottleneck, unless it is addressed, will be that house prices will continue to rise?

Mr Stevens—I do not want to make predictions about house prices, obviously, but I think what you have put your finger on here is really the point I was trying to make in the speech. I was not really trying to say, ‘Look, there’s a bubble,’ with implications that some people draw from that word being used. It is more that we need more dwellings and we need to be able to supply them without there being such a big elevation in prices, it seems to me, and I suppose one way of putting it is the way you have put it.

Mr MORRISON—I refer to the Henry tax review, which is underway at present. Any tax review, and you have seen a lot of them in your time, will sometimes focus on this question of housing and the treatment of housing and whether it is a productive investment or whether it is not a productive investment and all of those issues. But, given the supply bottlenecks that exist, are there any comments or discussion you would like to offer that you think would assist the tax review? Let me put it this way. What risks do you see in a tax review that brings down an outcome which might make it more difficult to get new houses built rather than making it easier?

Mr Stevens—To be honest, I do not know enough about what the review is doing and I am not a tax expert. So I am honestly not in a position to offer a constructive comment about that.

Mr MORRISON—There is another mechanism that is sometimes used to deal with increasing prices of assets, whether they be housing or other things. On a number of occasions going back to 2003—I think that may have been the earliest although it may have been well before then—in other papers you have made comments that talk about the bank’s role potentially to lean against the wind. I also note that in a recent IMF report there was some discussion in that report which suggested the RBA had basically done this in 2003. Whether that is true or not you are in a better position to tell me than I am to know. But at the same time we have seen some statements by a deputy governor which have been strongly critical of a leaning against the wind approach and by the Deputy Secretary of the Treasury. So what I am trying to understand is this. Has the RBA got a view that it has a future role in asset price inflation control, in particular in relation to housing, or does it not have that view?

Mr Stevens—That is a good question. I think that some of the things that you have made reference to were actually in a speech by one of the assistant governors, Guy Debelle, who is not here. He gave a speech that was interpreted in the way you suggest and it was apparently the case that there was a raging debate between Guy and the gentleman on my left over these matters. The two are the best of friends, I might add. It is a very difficult issue the one that you raise. I think we may have come at this on some previous occasions but it is worth a quick revisit, the question of what if anything monetary policy should do in response to large changes in asset prices. I think we ought to keep linked with that the associated credit build-up, because personally I think an asset boom and bust that does not have any leverage is unlikely to do all that much damage. It is the ones where there is leverage attached where you have got the problem, and most bubbles or big asset events will have leverage because that is how they really happen.

What should you do, if anything? One view, the Alan Greenspan view, is you cannot know it is a bubble until it has burst, so you should not do anything much, and then you should clean up the mess once it has burst. Another view, which has attracted some quite prominent, well-regarded people, holds that you should lean into an asset price credit swing with monetary policy by doing a bit more with monetary policy than you would do just on conventional demand-

supply inflation metrics. I think it is probably still the case that amongst most of my peers around the world there is not great consensus on this, and we have been debating this, at least in my memory, ever since the bursting of the Japanese bubble in the early nineties, so that is quite a long time.

In reference to 2003, I think what really happened was that there was a momentum building in the housing market. We had a lot to say by way of open-mouth operations at that time—my predecessor said a lot of things in order to try to get people to calm down—and we did have a couple of lifts in interest rates at the end of that year, quite close together. The way I would characterise those is that they were going to come anyway, for general inflation-targeting reasons, but we, at the margin, erred on the side of being pretty prompt and rather outspoken about them because the housing market dynamic was there, and there was a certain degree of success attached to that episode. So I think the framework we have had has on occasion allowed us to, at the margin, take account of these things, without it meaning that we forgot about everything else we were supposed to be doing and just said, ‘We’re going to chase down this asset boom that we don’t like.’

Now, that is kind of a roundabout way of saying I personally would not want to commit to saying, ‘We’re definitely never going to pay attention to asset prices and totally ignore them.’ That has been shown to be a mistake, basically. But nor do I think it is our brief to aggressively chase down asset things that pop up here and there that we might personally find hard to accept or agree with, at the expense of other things that we have as our objectives. So I think that, into the future, it is going to be a matter of judicious, careful use of our instrument in trying to meet all these worthy goals—keeping in mind as well that there is a whole separate debate about other tools that might be applied to booms and busts and asset prices. That is a whole separate section of this debate—what tools could be used by the supervisory authority to rein in the lending. There are big discussions and differences of opinion there too, and if one were to do full justice to this topic you would have to have a long discussion about that as well.

Mr MORRISON—I think you make a good point in that our financial regulation, particularly going into this crisis, combined with the fact that we have had a fairly significant undersupply in the market, has held house prices up, whereas around the world they have crashed, and I am sure that has had a positive effect on confidence. But, coming back specifically to the issue of housing and house prices and your comments about asset price inflation for housing, given that we have discussed that the issues here relate largely to supply bottlenecks, isn’t it far preferable that, from a policy approach, the priority be addressing supply bottlenecks rather than using monetary policy to put up interest rates to control house prices?

Mr Stevens—I would not be proposing a policy of raising interest rates simply because house prices were rising. It is one of the factors; it is one of the parts of the whole mosaic that is the economy to which we try to calibrate our instrument. But is it worth re-examining all these supply issues? I would say yes, without having any great expertise in being able to tell you how exactly that might be done.

Mr MORRISON—Given, again, the perception that rates are more likely to rise than fall, another issue that has become very apparent, particularly in the last 12 months or so, has been the reduction in the level of competition amongst the banks, particularly for new mortgages. We have gone from about one in five new mortgages being held by the non-banks to fewer than one

in 10. I wonder whether you could comment, firstly, on whether you think that the lack of competition is a problem and, secondly, on whether anything might need to be done there. Following that, I would not mind raising some issues regarding the securitisation market.

Mr Stevens—You are right that the market share of the major institutions has risen. Let me make a couple of points there. For some of the other players who did rely heavily on the securitisation process—as you know, that process basically stopped being feasible almost everywhere in the world—

Mr MORRISON—Except Canada—

Mr Stevens—So, what would we want the major banks to do in that environment? What I think we would want them to do is step into the gap and make sure that the total supply of housing finance was adequate. I am not here to defend the major banks, but it seems to me that one important piece of perspective to keep in mind here, I think, is that there is not a shortage of mortgage finance in Australia.

Mr MORRISON—No, I think that is fair.

Mr Stevens—Some of the discussion seems to proceed on the basis that there is actually a shortage here that needs to be addressed. I do not think there is. Mortgage approvals are up by a third since the middle of last year. If there is a tightness of credit issue, it is probably more in business lending than housing, I think. So, yes, there has been a market share change. I think that, given the set of events that we saw, that was highly likely to occur, because of the securitisation issue and also because some of the reliance on wholesale funding that some institutions had had was not going to be a very viable business model into the future. Institutions that had a stronger deposit base, just by the nature of the events which occurred in the global economy, saw their relative position strengthen and they stepped up their lending. As a result of that I do not think, really, that there is a shortage of housing lending in Australia.

Mr MORRISON—My point is not that there is a shortage of housing lending; my point is that there is a shortage of people lending for housing and deciding the terms and conditions upon which that finance is extended.

My last question on this issue relates to the fact that in Canada the securitisation market has largely remained open. I wonder whether you could reflect on how the Canadians have handled their securitisation market for mortgages as opposed to how we have, and why that has led to a high level of competition in Canada as opposed to here.

Mr Stevens—I do not have the fine details of the Canadian experience in front of me. It is true that there is securitisation there, and there is a government entity that guarantees those mortgages which is then put into the system. I am not aware what the evidence is as to whether their extent of provision of finance and its terms are actually superior to ours. I do not know the answer to that question.

Mr Battellino—The Canadian system has always been more inclined towards securitisation than ours has been. The Australian financial system is a very diversified system. There are a lot of avenues for getting finance, and different avenues do better in different parts of the economic

cycle. Through the credit boom the market share of securitisation rose very strongly and the market share of the banks diminished. Now we are seeing the reverse of that. I think that is just the natural working of the cycle. I do not think it is fair to say that there is a lack of competition in the housing market. In the last year or so, housing margins have diminished quite a lot, and that is the reason why securitisers have been forced out, because there was an increase in competition.

Mr MORRISON—You could also say it is because the nonbanks were paying high fees for their finance but their margins were made much more difficult and that forced them out of the market.

Mr Battellino—Yes, but that was coming from a situation where there had been an incredible credit boom around the world, and all those securitisers were finding it very easy to get access to credit. They were competing very aggressively against the banks and, in fact, outcompeting the banks.

Mr MORRISON—But in Canada they guarantee the securities, not the banks.

Mr Battellino—Yes, that is the case, and that is the same as the American model. Basically, they have a set of institutions there that guarantee the mortgages. But the question I think you have to come back to is: is there enough housing finance in the country at competitive yields? I think the answer in Australia is yes.

CHAIR—Also, I am reminded that the committee did an extensive inquiry into this late last year—before your time, Mr Morrison—and there was a great deal of evidence in relation to that.

Mr TURNOUR—Can I first congratulate the bank on the work that you have done to help us steer our way through the global financial crisis. I think that needs to be recognised as well. I just want to pick up on this housing issue and supply side issues, and the governor touched on this in some of his earlier comments. My experience in Cairns and the Far North Queensland region—and I have met with a range of builders and developers—is that developers, prior to the global financial crisis, were getting money literally pushed at them by the big four banks, looking to get them to expand their business. Following on from that, they pretty much were squeezing them and taking it all back. We are in a situation now where a number of developers that I have met with have sold—in terms of having unconditional contracts for—developments, and they cannot get finance for them. I see real risks in not being able to see those sorts of commercial developments go forward and the employment impacts that will flow from them, given that we still have some of those previous investments on the books at the moment and people employed in those projects. Is there a shortage of finance for banks? How do you see banks' behaviour in regard to this?

Mr Stevens—Is there a shortage of finance for banks or from banks?

Mr TURNOUR—What is the reason for this? Are they struggling still to get finance? They obviously reassess risk, but clearly this is a real problem in terms of the economy going forward.

Mr Stevens—The funding situation for banks internationally has improved a lot since, say, the end of last year. In terms of spreads they pay relative to swap rates and so on, it is still

elevated, but it is available. There is intense competition in the deposit market because most of the banks are seeking to get a bit more deposit funding relative to wholesale funding on board, for various reasons, so they are competing intensely for deposits, so that is pushing up those prices. That is all occurring. At the same time, as you say, they have reassessed risk. The story you tell of their being quite willing to lend up until a point of time and then that changing is, unfortunately, the old story with credit cycles. That happens time and again. It has happened in a much more savage way in other places around the world, but it happens to some extent here. I think, as I said earlier, it is much tougher—much tougher—for construction developers, residential and non-residential, to get finance now than it was. I think that is in part because the major banks are being tougher. It is also because, in some of these areas, the foreign banks were the most aggressive a couple of years ago and they are, of course, the ones, in many cases, who have suffered worst from the international financial turmoil, so they, relative to what they were doing, have cut back the most. And then some of the regional banks have also cut back. So that is certainly happening.

What can we do about that? That is the question. Apart from saying that the setting of monetary policy we have seeks to take that into account to the extent that we can—and I am not sure that that does a great deal—we have done that. Unfortunately, the world we are now in, along with every other country—we, the world, I am being general rather than Australia-specific here. There was not enough capital in the global banking system to support the risks they were running. That was realised too late. In the future, for a little while at least, the pressure is on for there to be more capital—and capital is expensive to get—and tighter credit. We are in a world now where there is less credit at a higher price than we used to be in—internationally. Australia gets affected by that, less in its impact than in most other places but there is still some impact and this is part of that.

In time I would assume that, given there is underlying demand for residential dwellings, at some point we will reach a stage where these projects are going to look more viable and less risky and the finance will be found, but I cannot quite say when that might be and at the moment I fully agree, it is quite tough. I do not have a magic button I could push to make that go away. Do you guys want to add anything?

Mr Battellino—Only to reinforce the point Glenn made that a lot of this cycle comes from the activities of foreign banks and, to some extent, regional banks. If you go back a few years, these banks were lending very aggressively. There was a period a couple of years back where the foreign banks, for example, increased their lending to the property sector by 40 per cent a year and, similarly, some of the regional banks had been growing very strongly. They are the ones who are now pulling back because some of those loans obviously did not work out and they are losing money on them. The core of the banking sector, the four major banks, they are still expanding their lending to the property industry through this period. So to some extent, they are providing a stabilising role around what the rest of the sector is doing.

Mr TURNOUR—I am talking about the experience that has been relayed to me of the big four banks—the ANZ, the Commonwealth Bank and the others. My concern in what you have said is that we effectively got into this problem through the global financial crisis, through the banks overlending and there being an imbalance in the valuations of properties across a range of areas. Now we are in a situation where we are trying to come out of this, the government is providing stimulus, the board is doing what it can in terms of cutting rates and you have said

very clearly in your speech, Governor, a few days ago that you are concerned about supply side risk. We are talking about housing in the \$300,000 to \$400,000 but I am talking about developments in those areas. Developers in Cairns just cannot get finance. That is the feedback I am getting. There has clearly been a reassessment of risk, but some of those developers have gone to the wall, not necessarily because of engagement with property markets but because of some other engagements in the share market and flow-ons from that, and some other inappropriate activities. But I am concerned that we are seeing the bank act, we are seeing the government act and we are seeing the big four banks in particular, from my experience, not actually looking at how they can get engaged in supporting the property area, the development area which you have identified in your speech where we need to see increased supply provided.

Mr Stevens—It is a problem, but to some extent—I do not want to sound like I am defending them—this is the way these cycles work out. I do not think that just saying to private banks, ‘You’ve got to lend more,’ per se helps much. If there was a thing that could ease this problem it would be something that clarified what the risk really is with these proposed developments more clearly. If the risk is being assessed as greater than it really is, the question is: what device clarifies that the risk is in fact lower to make it easier for them to lend? If they are correctly assessing the risk, we do not want them to take undue risk because that is a safety issue.

The real issue, I suppose, is: what is the genuine amount of risk in these projects? Obviously I do not know the individual circumstances in any detail, but what is the real risk and, if the assessment of that risk that is being taken by the potential lender is wrong in some way, how do you get them to see that more clearly? I do not know what the answer to that is, but I do not think the answer lies in just saying to them, ‘You’ve got to lend more.’

Mr TURNOUR—It is just a pity that they obviously stuffed up the assessment of risk in the lead-up to the global financial crisis, and I am a bit concerned that they may again.

Mr Stevens—The really big stuff-ups were in the US and the UK and some countries in Europe, in these big globally active banks—they were the really big stuff-ups. There certainly will have been things go wrong here but I do not think they were a major contributor to the global crisis. But there is a natural cycle of optimism and pessimism that we all have, and bankers have it too. It was ever thus, I am afraid. I know that is not very encouraging.

Mr TURNOUR—Following on from that, you touched on the international experience quite well in that speech. Obviously monetary policy, the level and the settings, is going to have an impact on people’s ability to borrow and on the housing market going forward as well. One of the things you touched on is the risk of international inflation from the very high levels of debt to GDP that are being run up particularly in the UK and Europe, in contrast to the situation in Australia. What do you see in terms of the inflationary risks internationally and how does the bank look to manage them in terms of the settings in Australia?

Mr Stevens—A very interesting bifurcation, I think, has been evident in the international debate. This was one of the things I was trying to articulate in that talk. On the one hand some countries have genuinely worried about deflation in the near term because of extremely weak demand, inflation already quite low and the feeling that they might get into a bit of a spiral of weak demand, prices falling, therefore people wait to buy because prices will be lower, which means you get more deflationary pressure. So some have worried about that, and some of the

exceptional things we have seen other central banks do really were an attempt to head off that risk. On the other hand there are other people who worry, and I think understandably, about the very large budget deficits that some countries are running—and we are not talking about Australia here; we are talking about countries like the US or the UK and some others that have 10 or 12 per cent of GDP deficits and gross debt burdens going to 100 per cent and so on. There are precedents for that kind of budgetary situation but they are wartime ones, and wars usually have inflation. So people who look at the long run look at all that and think, ‘Isn’t there a risk that somehow inflation will get going again?’ So you have got both these concerns: possibility of short-term inflation being too low, but possibility of it being too high in the medium term.

As I think about our own position and I think about the big swings in international inflation in the past, in the 1970s everybody had higher inflation than they had had before but some countries did better at capping that and getting back down again earlier than others. Countries like Germany, Switzerland, Japan and some others—most of the countries in Asia actually—had quite good records on inflation. Australia in those days was with the wrong crowd. We were with the Brits and others who went to very high rates and we took far too long to get those down. I think the lesson I draw there is that when there is a big international secular change in inflation rates you get affected, and you probably cannot help but be affected to some extent, but you have some choice about whether you are with the countries that manage it relatively well or with the wrong crowd. Next time we want to be with the right crowd, if that happens. I think that is important. How will we do that? I am not saying it is going to get going again in a big way. But if it does our best bet is to have an inflation target, a flexible exchange rate which lets us set our own monetary policy without being mechanically helped up by someone else, an independent central bank to pursue that target and broad political support for that framework. That is our best bet of having stable prices in this country in the long run, and that is what we have.

Mr TURNOUR—Just one final question to clarify. What do you think the time line is in terms of looking at the risks of potential inflation, if it is going to break out overseas?

Mr Stevens—It is probably a little while off yet because economies are very weak. There is a lot of excess supply. Overnight, we have had figures showing that Germany and France both had a little bit of growth in the June quarter, which is good. But this comes after a five per cent or six per cent contraction in the preceding quarter. So there is a lot of slack in those countries, and I would think that there is disinflationary pressure at the moment. The only way that could go wrong would be if expectations of inflation somehow started to creep up and drag actual inflation with that, because people respond to their expectation with their behaviour. The most likely way that would happen is if there were a lessening of community and political support for the idea that those countries should continue to pursue low inflation in their monetary policy. I do not think that is happening. If it did happen that would be a concern because that might dislodge expectations. But at the present time I think that is anchored and the slack in those economies ought to keep inflation reasonably subdued in the near term. It might be a different story for some other places around the world that do not have as much slack. I think we are okay at the moment for a little way ahead. These bigger fiscal things for those countries that people think about, they are more kind of five, 10-year horizon sorts of concerns.

Mr TURNOUR—So you are talking about the near term—one, two, three—

Mr Stevens—The next year or two. I think that is the most likely international outcome over that time.

Mr BRIGGS—Governor, I was reading yesterday a previous *Hansard* from the February hearing of this committee. I note that in February you commented about your optimism about China. You were more optimistic than others. Interestingly, that optimism seems to have borne some fruit in the March GDP results. Could you talk us through what you think the impact of the China story was on those results, particularly with exports defining the international trend. We had a large drop in imports, seven per cent, but we had a 2.7 per cent increase in volume in exports for the quarter. I am interested in your views on the impact of China on those figures.

Mr Stevens—It is certainly true I was in the optimist camp on China, because we could see even then certain indications that the drop-off in Chinese production was starting to reverse and that has certainly continued with a vengeance since then. In the June quarter the Chinese economy, we estimate, actually grew by four per cent. They cannot keep that up, but that is a pretty strong result and it has affected exports. I will get Phil to make a few remarks about export performance.

Dr Lowe—What has happened here I think is truly remarkable because if you look at the last nine months then our export volumes are probably up three or maybe four per cent. If we look at every other country around the world, their export volumes have fallen—in many cases by 10 per cent and in some cases by 20 or 30 per cent. So Australia has been able to sell more goods to the world in a period in which global trade has collapsed and industrial production has collapsed. There are a number of reasons for that but the main one is, in fact, China. Of our total exports 23 per cent went to China in the last quarter. If you go back 10 years, China was taking four per cent of our exports. So there has been very strong demand for resources in China, largely because of the fiscal stimulus that is going on there, and we have benefited tremendously from that.

Mr BRIGGS—Would it be fair to say that the good figure in March was in large part due to the China story?

Dr Lowe—There has also been a recovery in rural exports. We have had a partial recovery from the drought and we had quite a decent wheat crop after it had been weak for a number of years so that is part of the story. But the main story is China. China is now taking 80 per cent of our iron ore exports. It is taking more than 20 per cent of our coal exports. This time last year I think China took two per cent of our coal exports. So as demand from both Korea and Japan declined with their huge declines in industrial production, the Chinese stimulus was kicking in and the demand from China was really replacing the demand that we had previously had from Japan and Korea.

Mr BRIGGS—Bearing in mind, Governor, that you think this will continue—the large number was in June but there will continue to be strong growth in China—do you think it is concerning, when obviously the resources story is a big part of that for Australia, that there appears to be, certainly in Western Australia, an increase in industrial activity which threatens the consistency of supply to China? Is that a danger signal on the horizon for our story?

Mr Stevens—I do not know enough about that activity to offer much of an informed comment on that per se. But I think the general observation would be that in all these relationships reliability is obviously important, and that is no less true for the shipments to China than for those to Japan, Korea and these other historically quite important markets, some of which are also now starting to strengthen. So I agree that reliability is very important but I am not up on the specific dispute you are referring to.

Mr BRIGGS—Finally, I just want to take you back to a discussion you had earlier with Mr Morrison about the stimulus and when is it the right time to wind back, both at a monetary level from your perspective and the fiscal level from the government's perspective. Given that there is, as you describe, two paces to the government's fiscal stimulus—the one-off payments, which are through the economy now, and the ongoing projects and so forth—what is the signal which tells you that that should start to be wound back? Indeed is there a point, do you think, where the government should consider winding the already announced stimulus back from what they are doing—i.e. is there a point where building a school hall no longer has any benefit?

Mr FITZGIBBON—You still do not support that stimulus package.

Mr Stevens—Most of these things of course are scheduled to appear in a certain period of time and then not keep appearing so I think in 2011 the forecasts of most people, and certainly ours, have a negative fiscal impact. The stimulus is there for a year or two and then it fades so in terms of the growth impact it is a minus in that year. If things go according to that schedule or something like it then there will be an automatic winding back of those things at least as time goes by. So I suppose your question really is: would there be a case for them to be cancelled before they start?

Mr BRIGGS—What if we are doing better than the forecast.

Mr Stevens—If we are doing better than the forecast at some point, we will probably respond to that. Whether the government is able to or chooses to respond with discretionary changes in the already announced fiscal things is really up to them. I certainly agree that in due course there will be an eminent case for these discretionary fiscal measures to be unwound as they are currently scheduled to be. If the timing of that needs to change, Canberra will have to think about whether they can do that.

Mr BRIGGS—I presume you would agree with what the Treasurer has said: it is important that fiscal and monetary policies work together.

Mr Stevens—It is usually important that they do not work at cross-purposes, certainly.

Mr BRIGGS—Thank you.

Ms OWENS—I think I have crossed off 10 questions because they were asked and another 10 because they were answered.

Mr Stevens—So that means I didn't answer 10!

Ms OWENS—One of the great contradictions when we talk about aggregates is the sometime difference between the way the country looks as a whole and what people are actually experiencing. In the good times prior to the global financial crisis, for example, a lot of people in my electorate were standing on tiptoes, with their noses just above water. Now that there is a downturn, they are paying off their mortgages and it feels reasonably comfortable. There is this quite interesting contradiction. As we start talking about recovery, the concern is that a lot of the underlying conditions that we inherited—infrastructure bottlenecks and capacity constraints in skills—are long-term issues. How do we avoid going back to the situation where the country as a whole is doing well but so many people are standing on tiptoes?

Mr Stevens—I am not sure how successful we will be in avoiding regional and industry differences as a general proposition. I will come to the tiptoes in a second. If it remains the case that the emergence of China continues—let us say it has 20 years to run at pretty volatile but high growth rates and that in response to that the Australian economy continues to structurally adjust in the direction of supplying the demand that comes from there, though not just from China—that is what you would expect would occur. Those relevant sectors get bigger, the regions where they are get bigger, the industries which service them get more demand and certain other parts of the economy, relatively speaking, get smaller. There is a pretty good chance that that could happen as a structural adjustment. How do we cope with that? As a general rule I would say to try to keep flexibility and have measures that help people adapt geographically or vocationally. I would hazard a guess that some of the people who were on tiptoes were there because, to hark back to one of the earlier subjects we discussed, the level of house prices was high and the mortgage you needed to have to get the flow of housing services you wanted was big. I freely admit that a year to 18 months ago those people were being squeezed. We were running tightish policies trying to contain the economy as a whole. I admit that that is not a precise instrument. I do not have a precise instrument.

It is not that we are uncaring or do not notice those people, but we have to try to balance those concerns with the aggregate obligations. But we might ask why they were on tiptoes. I think we come back to some of the housing cost issues. We certainly would not want people to end up on tiptoes because they had a false set of assumptions about house prices, interest rates and so on, so we ought to try to be as clear as we can be about how the system works. I think we are being clear. I wonder whether some of the tiptoeing was because of some of the issues that we were talking about earlier, which of course I cannot fix, but I think they remain as potentially structural issues. If there were devices to try and fix them—and I do not know what those devices are—I think that is part of the story that you are so rightly worried about.

Ms OWENS—Of course, regarding consumer behaviour, really household behaviour—we were fuelling our own growth with our own Saturday morning shopping sprees, I think—do you see that behaviour changing now in the recovery? Do you think we will bounce back to that?

Mr Stevens—I would say that, if you looked over a five-year horizon, I would expect that it would be a little surprising if the process of gearing up, a low savings rate et cetera, which we saw for some years, was such a prominent feature of the future. That would be odd. It is certainly not going to be in other comparable countries. They are in a more savage adjustment of that behaviour than we are. Actually, if you look at the Australian economy in the five years up to now, consumption has not been as prominent in demand as it had been in the five years prior to that—it was more the investment that was strong. Household saving rates were low but they had

stopped falling. They were on the verge of coming up a bit. So I think there was already some adjustment. In the beginning it was not as clear. We are already in a period with an adjustment towards less gearing up, a bit more saving, a little bit more thrift. I suspect that was already coming. I would think that we might expect a little bit more of that in the future. You cannot be sure, of course, but that would be my guess.

Ms OWENS—Could that exacerbate the differences between the growth, say, in the mining sector and the more suburban kinds of—

Mr Stevens—No. To put it in your language, it is people trying to get down off tiptoes by getting the balance sheet a little bit stronger and containing the flow of consumption for a while while you do that. That would be what I am talking about. That would be a way of making sure you are not quite on such tiptoes next time.

Ms OWENS—You talked before about sharing the burden by many people reducing hours of work. That is happening right across the country. In terms of the level of national debt, we could also say that we, in a sense, share the burden—rather than individual families and businesses wearing the downturn, it is shared. What would be the ramifications of not doing that?

Mr Stevens—What would have happened if they had not had the stimulus packages, in other words?

Ms OWENS—Yes.

Mr Stevens—I think it is pretty clear from our earlier discussion that we believe that the fiscal measures have supported demand and, therefore, at least to some extent, output. There is a debt counterpart to that. If things evolve, as in the long-term projections that the government put out—which, by the way, were quite a good thing to do to illustrate that this is the path back to budget balance, capping the debt and having it eventually come down, relative to GDP; I think that was worth doing—then I think we will find that particular debt is manageable.

Another way of thinking about this—and you have seen this in a bigger way in other countries—is this. The private sector in other countries had too much debt. Suddenly it was going to retrench. And the shock absorber role was played by another part of the economy that has a strong borrowing capacity to, in a sense, take on debt, to buffer the economy for awhile—not permanently but temporarily. I think that is sensible to do, and I guess you can think of our government as having done a bit of that. Our need was less. Our capacity was greater. And they have done a bit of that too. And—provided it is temporary support while the private sector sorts itself out, and then the government gradually reverses that over time and things go back to roughly where they were—that will be a good outcome, if that is where we end up. It is just like interest rates: abruptly adjust, and then gradually normalise things as the economy normalises.

Ms OWENS—In terms of the level of debt, there are a lot of people in all of our electorates who do not remember the last downturn because they were, pretty much, teenagers at the beginning of the upturn. You hear stories that the level of debt will be there for the grandchildren of the students sitting behind us.

Mr Stevens—Public debt.

Ms OWENS—Yes, public debt. That is not right, is it? This is not a major generational burden.

Mr Stevens—Well, actually, my generation inherited debt from our grandparents. I think the key thing is to have the debt be of a manageable proportion. I think it was sensible, when the economy had a very long, strong upswing, to use that to run surpluses, to run debt down, because that is what builds the capacity to run it up when the rainy day comes, as it did. This is actually one of the troubling things about some of the major countries: they did not do that when the sun shone; the debt went up in recessions and then stayed there, and then, in the next recession, went up again. And that is how the G7 group is going to get to a debt of 100 per cent of GDP within the next year or two. In Australia, the debt to GDP ratio actually has a cycle: it goes up in recession—both automatically because the automatic stabilisers do that and then, if you have discretionary things as we have had this time and at other times, for that reason too—but then it goes down in recovery. And, if the recovery is long enough, it goes to nothing, as it did this time. That is, broadly, a very sensible way to run things. So it is about having it manageable. There is not actually a rule anywhere that I know of in economics that says, ‘The optimal amount of debt is nothing,’ for the government. It is certainly not 100 per cent of GDP. But it is not necessarily zero.

The issue is: is it, around a stable trend, manageable? If things emerge as they are projected to—and of course that remains to be seen, but right now I suspect the budget deficit is probably a bit smaller than was in the budget and the rate of debt accumulation might even be a little bit slower than we thought, though we do not know yet, but if things work out like that—then I think that will prove to be manageable.

Mr FITZGIBBON—Governor, I cannot resist the temptation to preface my question by remarking in response to Mr Briggs’s last line of questioning that the later phases of the government’s stimulus package are largely designed to address the very capacity constraints we experienced in our last period of high inflation. You can comment on that if you like; I do not mind. I am generally reluctant to ask you this question, because I do not want to drag you into the contemporary debate about the distribution of federal grant funding to the states, although I do note that every member of the committee here but one is a New South Welshman. But, when I was last on this committee, the buzz phrase—

Mr Morrison interjecting—

Mr FITZGIBBON—There are. The buzz phrase was, of course, ‘the two-speed economy’. We do not seem to hear it mentioned much of late—it certainly has not been mentioned here this morning—but last time I looked we still had a two-speed economy; I have not checked the state gross product figures lately, but I think it is still fair to say that Western Australia and Queensland are growing far more rapidly than Victoria and New South Wales. To what extent does the ongoing existence of that two-speed economy pose challenges for those who set monetary policy?

Mr Stevens—I think that, if we are honest, multiple-speed economies are probably more the norm than the exception. It is true, as you say, that the mining-intensive states are doing better but, by the way, I think you might also argue that in some respects the extent of the slowdown has been greater there too. Mining is coming back now, but six or nine months ago there was a

fair bit more pessimism about prospects for commodity prices and so on than there is today. So they have actually come back to the pack in some respects, and I think that the relative underperformance of New South Wales might in some respects have abated a little bit there. I think there will be swings and roundabouts in this dimension over time. So that is a feature of things.

I think our job, really, is to try to work out what are the big shocks affecting this economy at the moment and prospectively and how they will affect it—what will that do to overall growth, employment, inflation et cetera?—and then where we should be positioned given that. Sometimes those shocks are going to have a regional or industry dimension; sometimes they are going to have a kind of behavioural dimension. We talked before about asset booms and busts. That is a behavioural thing that often is actually right across the metropolitan areas of the economy. There will be other ways in which these things can occur. Our job is to try to work out what this shock is, how it is going to work through and what we should do in response. Sometimes they are going to be geographical or industry based and sometimes more general. As for the distribution of grants, I reckon there are probably about five people in Australia who really understand the formula, and none of them is sitting at this table here—I am not sure about your table, but certainly not this one.

CHAIR—Governor, I have a question about the payment system. The Payments System Board has presided over a significant reform agenda. Can you outline for us the key reforms to date and key decisions that are outstanding that remain to be made.

Mr Stevens—As you know, there has been some work done in a few areas, and I will probably forget some. Phil used to head that area, so I will turn to him if I need to get some support. There is a long amount of work done on card system interchange fees—a very bitter battle fought—and the result of all that was that we brought interchange fees down to 50 basis points. We did a number of other things which basically enabled more merchant choice in what merchants accept and which caused the consumers to face the price of the benefits they are getting in terms of points and so on. I believe that that was a very worthwhile set of reforms and it has had some quite good effects in clarifying for people what the choices are and bringing a bit of transparency and disclosure to what had hitherto been a rather murky world. That is one set of things.

There has been another set of changes, which were just coming in last time we met, on ATMs. The result of that has been that, at most institutions, foreign fees have disappeared. The owner of the ATM charges you, if they wish to, to use the machine. It is their machine, so I think they should be entitled to charge, but they have to tell you before you complete the transaction what the price is; you can decide to say no and go to another machine if you choose. As far as I can see, that reform has worked quite well. Many people can actually get a cheaper transaction now, if they shop around a little bit, than they could before, and they know what they are paying right now instead of belatedly when they get their statement. I think there were some fears that there would be gouging in particular areas or with time of the day transactions. Basically, as far as we can see, that has not happened. So that is another set of issues.

We have been trying to press the institutions which have stakes in the EFTPOS arrangements to update both the technical architecture of that system and its governance arrangements, and there is some progress being made there; it is not quite as quick as I had hoped but nonetheless

progress is being made. I think that is all good. There is quite a large strategic question here that the Payments System Board will be facing. The mandate that it was given in 1998 was to promote competition, efficiency and stability. With some of the retail payments system price setting, the problem was that it was not clear there was any competition. The Payments System Board has found itself in the position of setting standards in a way that would determine, more or less, particular prices in lieu of there being a clear, competitive process that would have done that. If it turned out at some point that we could be satisfied that there is a competitive process or that there is more competition between different types of payments systems—that is, the EFTPOS system is a strong, genuine competitor to the scheme credit card or debit card systems, for example—then it may be possible for the board to step back from such direct intervention into these prices, subject to those conditions. What is in debate at the moment is whether we are going to get to that set of conditions or not. That is as yet unclear. In the next six months we will have to make a judgment—probably sooner than that actually—as to whether there is enough progress there. They are the sorts of broad issues that we face. Have I forgotten anything?

Dr Lowe—No. That is all about the retail payments system. In the wholesale part, a very big issue globally is the use of central counterparties and central settlement facilities to try to reduce systemic risk. The US Federal Reserve just last week put out a number of proposals in that area. That is another general area of the Payments System Board's responsibility and I think it is going to be a focus over the next year or so as people look at how the international financial architecture can be reformed to give greater stability when institutions get into trouble, and the use of central counterparties is clearly going to play a role there.

Mr MORRISON—Governor, I am pleased that you have pointed out that debt does not just magically reduce and that governments have to decide to try to do that based on the overseas experience. Sometimes we talk about the G20 when it often looks like the D20, with debt and deficit. Can I draw your attention though to the big issue of the week in Canberra. Was the Reserve Bank consulted on potential impacts, particularly inflationary impacts, in the development of the government's Carbon Pollution Reduction Scheme, their ETS? If so, what was your advice or report to them on that? In particular, could you comment on whether you think the inflationary impacts of an ETS that included agriculture versus excluding agriculture would be greater or less?

Mr Stevens—As far as I know, there was no formal consultation with us on how to design this scheme or any other measures to address climate change. We have got some staff that seek to keep on top of the general climate issues, internationally and domestically, because at some point we will have to build into our forecasts the estimated impact on prices and activity and we will have to say how we will treat that from a policy point of view. In some of the previous hearings that we have had here we have covered some of those issues. But is there formal advice from the RBA to the government on these matters? No, there is not. I am not sure that it would be expected either. It is not a matter that we would claim to have expertise in.

Mr MORRISON—My question relates to whether you think there would be inflationary impacts as a result of their ETS and whether you think those inflationary impacts would be greater for a scheme that included agriculture rather than excluded agriculture.

Mr Stevens—I do not know whether they will be greater or less with or without agriculture. It is not a question that I have thought about. The set of proposals that were around going back a

way had some estimated impacts on prices, on consumer prices, that we were aware of, and we have discussed those in previous hearings. I cannot remember the figure but it was about a per cent, I think, in year 1.

Dr Lowe—If the price of carbon is \$10 a tonne, which is lower than was originally thought, that would add around half a per cent to the CPI in the first year and then more if the price of carbon were to rise over time.

Mr MORRISON—So given the CPRS has a staged introduction at various levels of pricing carbon I suppose with the way that permits are introduced, auctioned and so on, it is fair to say that the inflationary impacts of such a scheme would not be a one-off and would have multiple impacts as the various stages of the scheme were unfolded?

Dr Lowe—As I said, in the first year it would add 0.4 to the CPI. Then if the price of carbon were to go up to \$30 a tonne, for example, which I think some people estimate, then that would add another 0.8 when that occurred. If the price of carbon continued to rise, that would add to the CPI. But if the price of carbon were to stabilise at, let us say, \$30 a tonne, then there would not be very large ongoing effects on inflation. It would be more a one-off adjustment.

Mr MORRISON—But it is unlikely that is where we are going to start. I suspect that may be where we may end, but there will be a pathway to it. On another matter, the bank guarantees, what do you believe are the preconditions for the withdrawal of the government guarantee for retail deposits and the government guarantee on wholesale funding? What do you think the likely time frame is for those preconditions to be met?

Mr Stevens—There are a few elements there. I do not think that the likely ending point, at least as things look at the moment, for retail is that the financial claims scheme, which in the event of a failure of an ADI allows early access to money up to a limit, presently a million dollars—that scheme with that parameter of a million dollars—could be changed. The scheme is in legislation now, I think, so that is going to be there. Most countries have some kind of deposit insurance, so that is likely to persist.

On the wholesale front, when the pricing of the fee for the guarantee was set it was set in a way that we hoped would be such that when market conditions normalised it would be too expensive to issue with the guarantee and would naturally therefore fall into disuse. We are probably not that far actually from that stage. I think that it would be good for our institutions to just start to issue in their own name anyway as much as they can. That is happening in other countries. I think that conditions have pretty much now sufficiently stabilised that it would be sensible for them to start doing that even if it did cost slightly more in the short term, and I have said that publicly. But of course they will make their own decisions. But I think that we are not far now from a world where those wholesale guarantees will not be needed.

Most countries actually put an end date for when the guarantees would finish. A number of them have had to extend it but for most of them it is the end of this year. Really, if all those countries allow that to come to fruition and the guarantee is no longer available, I cannot really see why we are going to need it much longer. We have not set an end date. We have just left it open-ended, subject to being reviewed as we observe conditions. But I would say that we are not far now from a world where we do not really need to have the banks using those guarantees.

Mr MORRISON—And lastly, there has been a lot of discussion this morning about your more positive views on the economy and where it is tracking ahead over the next little while, and the view that is not necessarily yours but a prevailing view about where people thought things were late last year and the various forecasts that were developed particularly by the government for the budget. With a more optimistic view going forward, do you think that the level of debt and deficit as framed by the government in the budget may have been overstated and therefore any reduction in those figures that we might see later would simply be a matter of a revision of forecasts rather than anything structural?

Mr Stevens—I will answer in two bits. Actually the point of maximum pessimism was probably about the time that the budget was being drawn up. That was certainly the low point for our projections. Now how the government chooses to revise the forecasts later in the year for MYEFO and so on is entirely up to them and I am not involved in that. If we assume that they revise up as well, I would expect that the budget deficit prospectively will look smaller. My guess is that it already is in fact smaller now as a matter of fact than was expected, because the economy is a bit stronger.

You will be able to tell though, how much of the change in the prospective deficit and debt build-up is parameter change and how much is due to discretionary things, because that is all as a result of various reforms to the disclosure that were done over the years. That is all in there so you will be able to tell. I do not think that it will be able to be hidden.

CHAIR—Thank you. We have some students with questions.

Mr Stevens—Mr Chairman, one of the earlier students asked the question about the accounting and the environment. Some of our staff actually emailed through an answer on that. I will not take time to do it in public but we would be happy to convey that privately, if she would like to hear it.

Natasha Spencer—One of the fundamental reasons for the economic state across the globe is the excessive use of credit or simply consumers living beyond their means. Doesn't the current raft of stimulus packages being deployed by the governments around the world give rise to this same thing happening again?

Mr Stevens—If they were carried too far they could, but much of what has been done internationally is to do two things. Firstly, it is to support financial systems, including in some countries the government actually taking ownership stakes in banks where the private sector could not come up with the requisite capital. We have not had to do that in Australia but in a number of other countries they have. That is about stabilising the financial system and making sure that, as quickly as we can, the banks are able to provide credit for proper investment purposes by businesses and households, and that is a good thing to do, not a bad thing to do.

The other component, I suppose that is good to do in the short term, is just temporary support of demand at a time when private demand is collapsing because people are suddenly fearful and trying to get their own debt down. I think that it is okay to do that. It will be important in the future that the governments in their respective countries know when to cease doing that and step back and restructure their own balance sheets, and especially in some of the North Atlantic countries that will be a big task. I think that it will be important that households and businesses

and lending institutions do not get carried away again with too much leverage and too much confidence there. There are a number of reforms to regulatory arrangements being worked on around the world to try to counter that and make sure that that does not happen again.

Michael Shen—Mr Stevens, in your statement in the first half of this session you made the claim that the Australian economy is recovering from the recession earlier and faster indeed than other economies. However it is clear that many sectors of the economy are still extremely weak and uncertain. For example, the unemployment rate is still projected to rise to 8.5 per cent by 2010 and the only reason it has slowed currently is, as you said, due to part-time employment and underemployment, which means more workers working but working shorter hours. In light of this tumultuous economic condition, how can the RBA justify the raising of interest rates in the near future, considering that many sectors of the recovery are attributed to the low interest rates, such as the household boom?

Mr Stevens—I think that there are a number of sectors of the economy finding better conditions than had been expected. I do not think that it is just confined to one or two. In most surveys, though it is not uniform, there has been a lift in confidence and conditions across quite a number of sectors.

I do not think that it is true that the rise in unemployment being smaller than expected so far is just because of so-called sharing the work around. I think that it is also the case that the weakening in economic activity has not been as great as was thought at one point. I would also say that the chances are now that we are not going to get the 8½ per cent peak in unemployment. I know that was the government's forecast and our own forecast at that time probably would not have been all that different. The chances are now, I think, that the peak is going to be noticeably less than that. And so that is what I would say to all those things which were part of your question.

The other part of the answer is that when the time comes to lift interest rates from these very low levels, it will be because the emergency setting is not needed because the emergency has passed. That will be the logic when the time comes.

CHAIR—Thank you, Governor, for again making yourself available, and your staff available, to answer the questions. It is truly appreciated. It is an important process to go through to make sure that parliament and the public get to ask you these questions in this environment and hear your answers as to what the board is currently thinking. So thank you again for your attendance here today.

Resolved (on motion by **Ms Owens**):

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 12.35 pm