COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2006

WEDNESDAY, 21 FEBRUARY 2007

PERTH

BY AUTHORITY OF THE HOUSE OF REPRESENTATIVES

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **http://www.aph.gov.au/hansard**

To search the parliamentary database, go to:
http://parlinfoweb.aph.gov.au

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Wednesday, 21 February 2007

Members: Mr Baird *(Chair)*, Dr Emerson *(Deputy Chair)*, Ms Bird, Mr Ciobo, Ms Grierson, Mr Keenan, Mr McArthur, Mr Secker, Mr Somlyay and Mr Tanner

Members in attendance: Mr Baird, Ms Bird, Mr Ciobo, Dr Emerson, Ms Grierson, Mr Keenan, Mr McArthur, Mr Secker, Mr Somlyay and Mr Tanner

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2006

WITNESSES

BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia 1

EDEY, Dr Malcolm Lawrence, Assistant Governor, Economic, Reserve Bank of Australia..... 1

LOWE, Dr Philip William, Assistant Governor, Financial System Group, Reserve Bank of Australia..... 1

STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia 1

Committee met at 8.00 am

BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia

EDEY, Dr Malcolm Lawrence, Assistant Governor, Economic, Reserve Bank of Australia

LOWE, Dr Philip William, Assistant Governor, Financial System Group, Reserve Bank of Australia

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

CHAIR (Mr Baird)—I declare open this hearing of the House of Representatives Economics, Finance and Public Administration Committee and welcome representatives of the Reserve Bank of Australia, the students and staff from secondary schools in the Perth area, members of the public and the media. I acknowledge the role of Michael Keenan, the member for Stirling, in encouraging the committee to visit Perth. I understand that this is the first visit of this committee to Perth. The hearing today provides an opportunity to examine in more detail the recent easing in inflation and identify whether there are any lingering inflationary pressures over the short to medium term, particularly in view of the tight labour market and increasing capacity constraints. The committee will also seek views on other significant issues, including the housing market, labour market shortages, the two-speed domestic economy and the state of the international economy. In relation to housing and construction, the committee will be seeking to examine the extent of variation across states. Household spending has picked up modestly in 2006. The committee will examine the debt to income ratio, which has continued to increase, along with the household interest payments ration.

On behalf of the committee I welcome the Governor and other senior officials of the Reserve Bank of Australia to this hearing. I note that this is Mr Stevens's first appearance before the committee as governor of the bank. I take this opportunity to congratulate Mr Ric Battellino, who last week was appointed to the position of deputy governor. 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. Before I ask the Governor of the Reserve Bank of Australia to make an opening statement, I would like to acknowledge the presence of students from a number of schools from within and around Perth. Mr Stevens, please make your opening statement, at the conclusion of which we will proceed to questions.

Mr Stevens—Thank you very much. It is a pleasure for my colleagues and I to be here with you in Perth. Looking out at the beach this morning I wondered whether we should all be in our Hawaiian shirts. It is nice to be here. I have attended most of these hearings, in fact, since they started in their current form back in May 1997. Over that time, they have become quite an important part of the monetary policy framework in Australia, and I look forward to contributing to them in the years ahead. I am sure that the importance of these hearings will grow.

It is fitting that we meet here in Perth in Western Australia, where the effects of some of the profound international forces affecting the economy are perhaps clearest. I refer of course to the rise in the relative price of natural resources, which has increased incomes for shareholders and

employees in the that industry. It has increased labour and capital into the resources sector, and has had a flow-on effect on a range of other industries. That has fostered a very expansionary set of conditions in Western Australia in particular, though the effects have spread around the country.

This change in relative prices is welcome, but such events are rarely uniform in their geographical or industry impact, and this one is no exception. In the south-eastern parts of the country, where direct exposure to the resources sector is smaller, the positive impact is not as strong. In addition, the other dimension of the change in relative prices to which I refer—the relative decline in prices for many internationally traded manufactured products as a result of the emergence of China and so on—is affecting local producers. Not surprisingly, those parts of the economy, while growing, are not experiencing as much strength as here in the West.

Nonetheless, the rise in Australia's terms of trade of over 30 per cent over the past three years and 40 per cent over five years, taking them to their highest level for over 50 years, is expansionary overall. The real incomes of Australians are higher and, other things equal, this adds to demand. For macroeconomic policy, it is a matter of ensuring that the economy adjusts to the change as smoothly as possible. That task is considerably easier today than it once would have been. A more flexible economic structure, a floating exchange rate and a better macroeconomic policy framework mean that the adjustment is proceeding much more smoothly than it did on some other occasions in history when the terms of trade rose steeply. As a result, such adjustments to monetary policy as have been needed have been gradual.

When we appeared before you in August last year in Sydney, the economy was in the midst of a mild pick-up in inflation. This was something that we had anticipated would occur, and to which monetary policy had already begun to respond with adjustments to interest rates in May and August. As you know, there was a further adjustment in November, taking the cash rate to 6.25 per cent, somewhat above its medium-term average.

The background to the rise in inflation, and the associated adjustments to policy are, I think, quite well known. In the broad, after a long period of fairly solid economic growth, we have approached what for practical purposes can be called full capacity, at least for the moment. The evidence for that proposition is quite widespread. In the labour market, we are as fully employed as we have been at any time in the past 30 years or more. The share of the working age population employed is at a record high, the rate of unemployment is at its lowest for a generation, and wider measures of 'underemployment' are also comparatively low. It may well be possible for these trends to go further yet, but a wide array of business enterprises the bank talks to in our regular liaison have been saying for some time that it is harder and more costly to find appropriate staff, and that the factor most constraining further expansion is not insufficient demand but insufficient capacity, either of labour or capital or both.

To approach full employment is, of course, something that we should and do welcome. It is a goal of economic policy—it is, in fact, in the Reserve Bank Act as an objective. If full employment is a 'problem', so-called, it is the problem you would rather have than the problem of chronic unemployment. When we do not have full employment, it is appropriate—inflation considerations permitting—for demand growth in the economy to be faster than normal so that we can get those unemployed resources back to work. In the recovery from a downturn in the business cycle, that is typically what policies are seeking to achieve.

But by the same token, once full employment is more or less achieved, the pace of expansion in aggregate demand that was earlier desirable will now be too fast. It has to slow down a bit—not stop altogether—so that it is more in line with the rate of growth of the economy's productive capacity. Otherwise, we would face the problems of overheating, inflation and eventually another downturn. It is that adjustment to more moderate outcomes for spending and output growth which we have been seeking in Australia in recent years.

That this is necessary is I think confirmed by the fact that inflation has picked up somewhat. In 2003, CPI inflation was 2.4 per cent; in 2004, 2.6; in 2005, 2.8; and, as you know, by the middle of last year it was almost four per cent. To be sure, the CPI as measured was affected by the rise in oil prices, which had more to do with external events than Australian ones, and, most spectacularly, by the effects of the cyclone on the price of bananas—which gave the headline writers and cartoonists a lot of raw material to work with. But the rise in prices was more widespread than just those items. Measures of underlying inflation, which are less affected by those specific price shocks, also suggested a pick-up, albeit a much more modest one, from around 2½ per cent to about three per cent by mid-2006.

A short-lived pick-up of that magnitude is not necessarily a major problem in itself. But in an economy with limited spare capacity, continuing signs of pretty solid growth in demand and facing a quite expansionary external shock, that gradual trend rise in inflation was somewhat troubling. A continuation of that trend could well have seen inflation exceeding the two to three per cent target on a more sustained basis even after temporary factors had disappeared. And it was that risk—rather than bananas or petrol per se—to which monetary policy had to respond. The intention was that the rise in interest rates would restrain the growth of demand to some extent, allowing the supply side of the economy some time to catch up, and so act to improve the demand-supply balance and contain inflation over time.

So how do we read things at present? Most indicators suggest the economy continued to expand at a moderate pace through the second half of last year. Housing construction has remained a bit below average, but non-residential building and large-ticket engineering construction have been very strong indeed. Consumer demand picked up a little pace, and presumably at present it is also getting some help from the decline in petrol prices. At the same time the very serious drought has strengthened its grip on the rural sector, and so rural production and incomes will be considerably reduced this year. Meanwhile, demand for labour has remained very strong, with above average gains in employment and a further decline in unemployment through the turn of the year, and data on job vacancies and business surveys suggest not much change in that trend in the near term.

If we look abroad, the world economy continues to post quite a strong performance, led by the US and China. Many commentators have for some time pointed to a downside risk in the US, stemming from the possibility that a weak housing construction sector would pull down activity in the rest of the economy more than expected. To date, at least, that risk does not seem to have materialised. Housing is quite weak there, but overall the US economy seems to have been recording growth pretty close to trend, even with that housing sector being weak. At the same time—and this is quite important—recent inflation outcomes in the US have come off a bit, which is quite good. There is little sign that China's expansion will end any time soon, and recent outcomes in the euro area have been at their strongest this decade. So while it remains the case that forecasts made by the IMF and various other bodies for the global economy continue to

be qualified by statements about downside risks, at the moment, anyway, it seems that recent trends have been at least as strong as the forecasts, and not for the first time.

Prices for some commodities have retreated from their peaks, but others have remained quite high. The prevailing level of prices in this area will, surely, continue to prompt high levels of investment in the resource sector both in Australia and abroad. In time, the expansion in capacity that results from that will probably put some downward pressure on commodity prices. Nonetheless, our judgement remains that Australia's terms of trade will be higher on average over the years ahead than they tended to be through the 1980s and 1990s.

International financial markets remain remarkably supportive of growth. Long-term interest rates, which reached 50-year lows only a couple of years back, remain not far above that low now—even though short-term rates have risen back towards normal in most countries, except Japan. Share prices have been rising steadily, appetite for risk is strong, and volatility in prices for financial instruments has been remarkably subdued. To some extent, these trends in financial pricing may reflect a genuine decline in some dimensions of underlying risk. Variability in economic activity, and in inflation and interest rates, has clearly diminished over the past 15 years in a number of countries, including, in particular, Australia. So, in some sense perhaps, macroeconomic risk genuinely has been a little bit lower.

The associated prolonged period of attractive, steady returns on equity investment and the low cost of long-term debt funding certainly seem to have set the stage for a return to somewhat higher leverage in the corporate sector. As we all know, this is most prominent in the rise in merger and acquisition activity and in the re-emergence of leveraged buyouts around the world. Corporate leverage had been unusually low in the 1990s, as a response to the excessive leverage of the 1980s, so some increase in leverage at the moment is probably manageable. Nonetheless, after a decade or more in which the main action in many countries has been in household balance sheets—in this country and in a number of others—this trend in corporate leverage will bear watching over the years ahead. For the time being, at any rate, financial conditions are providing ample support for corporate investment and household spending around the world.

Turning now to the outlook for domestic demand, the very high rates of growth of business investment that we have seen in recent years are almost certainly now behind us, but the current high levels of investment are adding to the capital stock of the country in a way which should, in time, ease capacity constraints. It is noteworthy that governments in several states, conscious of the need for public infrastructure, are also looking to expand investment. There would appear to be considerable competition for the resources needed to complete all these projects.

A gradual expansion in residential construction activity should get underway over the coming year. We expect household consumption over that time to grow at about trend. In both these areas, we are taking account of the fact that the impact of the monetary policy adjustments that we made last year are still working their way through the household sector.

All of this should mean that domestic demand will rise at, or slightly below, trend pace over the coming year. With some export sectors expanding as additional capacity comes on line, our central forecast is for non-farm GDP growth to pick up from currently a bit below trend to about trend growth over the next couple of years. Total GDP growth will be lower in the short term because of the effects of the drought. If rainfall patterns improve in the period ahead, there

would presumably be some recovery in the farm sector in 2007-08; but, of course, the likelihood of that—let alone how strong it would be—we cannot know at the moment.

So far as the outlook for inflation is concerned, at the time of our November 2006 statement on monetary policy—after we had made three adjustments to interest rates last year—we believed that there were grounds to think that the higher inflation that we had seen up until then would moderate a little in the period ahead. Admittedly, we were a little tentative about that judgement but, based on that assessment, the board elected at its meeting in December to leave rates unchanged.

At our most recent meeting two weeks ago, we felt we could be a bit more confident in that inflation outlook. We will see some very big movements in CPI inflation over the coming year. It will fall quickly over the next six to nine months, from over three per cent currently to less than two per cent on an annual basis, as falling petrol and banana prices have their effect. They are, of course, temporary impacts on the annual inflation rate and, as they fade, the CPI headline inflation rate, measured on an annual basis, will go back up again to, we think, around 2¾ per cent by this time next year and remain at around that rate after that—that is, it will be lower than the rates we have seen in the past year or so but closer to the top, rather than the bottom, of the two to three per cent target range.

With that outlook, the board decided two weeks ago to maintain the existing setting of cash rates. We will be maintaining a close watch on what incoming information tells us about the prospects for inflation. The apparent softening in underlying inflation in the December quarter was certainly a very welcome result, but it is not yet clear to what extent that signals a persistent, as opposed to a temporary, phenomenon. Most of the indicators we have available still suggest a very fully employed economy, so there would be some risk of inflation remaining uncomfortably high were demand growth to be unexpectedly strong in the near term. The outlook for demand and the extent to which capacity constraints are being eased in a range of sectors will be key elements in forming a judgement about the inflation outlook and the appropriate stance of policy.

Let me now turn to payments policy, which I know is a matter of some interest to this committee. You conducted some hearings last year into these issues and we believe that was a very useful way of airing the views of the various participants. In 2002, when the Payments System Board announced the credit card reforms, it committed to reviewing the outcomes after five years. We will meet that commitment with a review, starting soon, which will take up this year and part of next year. It will be broad in scope and it will include all the bank's reforms to date.

I know that some industry participants have expressed reservations, including to this committee, about the bank, as opposed to some other body, conducting that review. I note that the committee was not convinced by those arguments and concluded that the bank should conduct the review. From our point of view, having publicly said that we would conduct the review, we feel that we could hardly do other than carry out that commitment. And it would be very odd for the Payments System Board, which has been charged by the parliament with making payments policy, to ask another body to review its decisions. It is, of course, open to the parliament, through this committee or in any other way it might choose, to review the reforms in any way that it sees fit, if it wants to, and to ask the Payments System Board to account for its decisions.

In December we announced the outline of the review, after inviting input from the industry. The formal part of the review will begin midyear, when we release an issues paper which will form the basis for an initial round of consultations. As background, I will also be undertaking some detailed research into the costs of the various payments mechanisms. That will update and broaden the costs study that was done seven years ago. We will also be undertaking research into the usage patterns of various payments mechanisms through surveys.

The review will be an open process. It will include a conference towards the end of the year that will bring together policy makers, specialist academics and industry participants. We hope to release our preliminary conclusions early next year and then consult again before announcing changes to the current arrangements. This should all be completed some time in the second half of 2008. That is a lengthy process, and no doubt some people will feel that such a long process adds a measure of uncertainty, but it has to be a lengthy process if we are to have all the facts, hear what everybody has to say, duly consider those views and then undertake proper deliberation.

Finally, while the Payments System Board's reforms to retail payments systems have attracted a good deal of attention, the board is concerned with a much broader set of issues, including the stability of the payments system. Here the main focus is the operation of the high-value payments system, in which the Reserve Bank itself is a major participant and an overseer of other parts of the system. Those systems continue to operate with a high degree of reliability and security and we are well served by them, but continued attention and investment on the part of the principal players, including the Reserve Bank, will be needed to ensure that that remains the case over the years ahead. That concludes what I would like to begin with. My colleagues and I are at your disposal.

CHAIR—Thank you very much, Governor. I appreciate your comments. Is it the wish of the committee that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication? There being no objection, it is so ordered. We will proceed to questions.

Governor, in the last week of your quarterly statement, the RBA lowered the expectation of underlying inflation from three per cent to around 2.75 per cent. In relation to the CPI, page 5 of your statement reads:

> It will probably fall noticeably below 2 per cent on an annual basis, as falling petrol and banana prices have their effect. After that, it will rise again, as those temporary factors fade, and we currently expect that CPI inflation will be around 2¾ per cent by early 2008, remaining around that rate thereafter. That is, it appears likely to be lower than recent outcomes, but closer to the top than the bottom of the 2–3 per cent target range.

Given that you have indicated that it is going to be closer to the top rather than the bottom, isn't it more likely that interest rates are going to rise rather than fall?

Mr Stevens—Yes, that is right. If you think the forecast is in the top part of the range and the distribution of possible surprises is symmetric—and that is what we would say at the moment—then the likelihood that you get some surprising set of events that takes us above the target is higher than the likelihood that you would get a set of events that takes us below. It follows more

or less axiomatically from that that, as a statement of probability, a rise is more likely than a fall. So, if that is what you are asking, yes, that is the answer.

CHAIR—But, on the overall balance, you think that a core inflation rate has settled to a stage that there is less probability than not?

Mr Stevens—We have seen a sequence of events that gives us more confidence that the inflation rate will not stay at three or higher for the next couple of years. Six months ago that seemed to be the outlook we were facing. That was not an outlook we were all that comfortable with, so we were raising rates. The fact that we have raised rates helps to contain those inflation pressures, as we said in the November statement. The recent outcomes give us a bit more confidence that the tentative forecast we made of some moderation in inflation in November will turn out to be right. We are more confident of that now and confident enough to write it into the forecasts in the statement. So that is a considerably more comfortable position than we were in in August or November.

CHAIR—In retrospect, oil prices seemed to be the main determinant.

Mr Stevens—Oil prices certainly were important and they were a big part of why the inflation rate got as high as almost four per cent. But, I do not think the whole story was just oil. The reason we look at various measures of underlying or core inflation is to try to strip out as best we can these temporary price shocks. Those measures did show a pick-up—not as big a pick-up as it could have been; inflation was not getting out of control by any means, but it went up to some extent. We felt that on the balance of probabilities it was appropriate to respond to that with some tightening in order to make sure that it did not continue and indeed in due course came down. So it was not just oil. Even though petrol prices have been prominent in the headline CPI, it was more than just that.

CHAIR—I turn now to the question of state differences. The huge imbalances in the drivers of Australia's economic growth seem to be getting worse rather than better and, being in Western Australia, it is probably appropriate that we think about that. The *Sydney Morning Herald* this week referred to your visit to Western Australia under the headline, 'Governor in economic hothouse'. It said:

> The minerals-rich west has been supercharged by booming commodity prices, with just about every economic indicator at some kind of extreme. Figures last week showed unemployment in WA is at an ultra-low 3.0 per cent compared with a 4.7 per cent average in the rest of the country. This week statistics showed prices of established homes in Perth rose 37 per cent last year, compared with a national average of 8 per cent. Spending in WA grew 7 per cent in real terms over the past year, versus less than 3 per cent in the balance of the nation.

Some economists estimate that Western Australia's economy is growing faster than China's, but New South Wales is in recession. When is this enormous growth gap likely to be reversed?

Mr Stevens—There certainly are some profound differences in the pressures the various regions are facing. The rise in resource prices has been very large. The terms of trade for Australia are at the highest level since the early 1950s. That is not an event that comes along very often. That does have a very big effect on Western Australia.

You mentioned house prices. The evidence seems to be that the rate of growth of house prices has begun to slow down. In the latest quarter the rise was much smaller than it has been, and the annual rate of growth, which was well over 40 per cent at one point, seems to be tailing off. It is probably worth remembering that the differences across the states, while noticeable, are perhaps not quite as big as popular opinion and commentary like to say.

For example, it is true that New South Wales is growing below average at the moment. That is not at all surprising. In the current circumstances it will not be Western Australia or Queensland that grow below average; they will be above average, helping to pull the average up. The south-eastern states are more likely to be growing below average. Even so, over the past year employment has grown in New South Wales and the unemployment rate has fallen. It has not fallen by as much as elsewhere and employment growth is not as strong as the national average and a range of demand indicators are also below the national average in New South Wales; nonetheless there has been some growth.

These regional differences are inevitable, given the external environment the economy faces. We cannot make that go away. It is a matter more of helping the economy as best we can to adjust to that. This adjustment is proceeding considerably better than it might once have done. Labour and capital resources are shifting to the strong parts of the economy where they are needed. Relative wages in those industries are rising relative to others, and that helps the labour resources flow. That is what is supposed to happen in a shock of this nature. While it is not without a few bumps on the road, this adjustment is not proceeding too badly.

CHAIR—The rental market has received some attention in the *Australian* today. You would have been there at the time listening to the Governor of the Reserve Bank when he talked about his concern about the government's policy on negative gearing. He thought we had gone too far on this issue and he encouraged people to look at other sectors in which to invest. Now we are faced with a so-called rental crisis. In the figures quoted in the *Australian* today, in Perth over the past 12 months the rental increase has been 18.2 per cent for a three-bedroom house and in Brisbane 16.3 per cent. The lowest rate rise was in Sydney—3.8 per cent. Does the RBA still have the same view about negative gearing? Secondly, is this a sign that the housing market has bottomed out and is in rebound activity and that prices are likely to move, which the RBA may be concerned about?

Mr Stevens—I also read about the rental crisis in the papers—of course, everything in the media is a crisis. Is it a crisis? I am not sure I would use that word, but it certainly is a tight rental market. What we know is that rental vacancy rates are low right around the country; no particular region stands out all that much. It is quite common. But let us think back to what the fundamental economics are here—and there is some material in our latest quarterly statement on this. The fact is that because of the much higher price level for housing around the country, the rental yield, which is the actual running yield as a return to the investor for holding that investment, is quite low. I think the chart in the statement shows that rentals relative to incomes have been falling for a long time—in Sydney in particular for a very long time—and they are quite low. So the rental yield of two or three per cent is quite a low yield.

In the period when the investor was getting a return from price appreciation he was getting some of the return that way, so the rental yield did not seem to matter so much. But it is hardly sustainable for a major asset market to continually give you most of your return through capital

appreciation. That does not sound to me like a sustainable equilibrium. Ultimately, the running yield, the rental yield, has to be higher than it has been. That is what is starting to happen.

In time, as the rental yield improves, I expect there will be more interest on the part of potential investors to supply rental accommodation, so the market will work. But at the moment, you have a tight supply situation because the rental yield is very low—historically quite low. One way or another it is going to need to rise. That could happen by the rentals going up; it could happen by the prices coming down. In many financial asset markers that is what would occur: the price would fall until the yield came up. We have had some price decline in some of these areas but not all that much. So one way or another that higher rental yield will need to be re-established and that will alleviate this excess demand situation.

Dr EMERSON—I would like to develop the line of questioning of the chair in relation to the inflation outlook. The statement on monetary policy of 12 February states:

... it remains possible that the upward pressure on inflation that was evident for much of last year could re-emerge.

It also states:

... many of the factors that have pushed up underlying inflation over the past few years persist.

In the statement today you talked about the Reserve Bank maintaining a close watch on incoming information and said that the outlook for demand would be very important and one of the variables that you will be particularly focusing on. In light of the answer that you gave to the chair's question about the outlook for inflation and the probability distribution that you described, the fact is, after that statement on monetary policy, the markets had factored in only a 20 per cent chance of a rate rise. Did you intend to give that sort of impression in the statement on monetary policy or do you think, building on your answer to the question that the chair asked, that there is a higher probability of a rate rise?

Mr Stevens—I am not sure I want to try to quantify what the probability is. The market, for better or worse, is putting a quantified probability on that. What we were trying to do is to say that, while the December quarter outcome is certainly a very good figure—and if figures like that keep coming in then life is going to get much easier—it is possible that there is a little bit of statistical noise in that even in the underlying series. It is possible that the genuine amount of inflation in the economy is a touch higher than that number suggested. There are reasons to think that. One of them is that the producer price measures or what people refer to as the upstream prices are certainly not still accelerating but they have not slowed down and they are running at around four. Official measures of wages to date—there is a figure out today; I do not know what that will say—so far have been actually pretty well behaved.

A very widespread comment to us from businesses we talk to is that there is upward pressure on labour costs. That does not necessarily mean they can put their price up in response to that, it depends on how strong demand is, but that force is at work in a very tight labour market. So those sorts of bigger forces that we think about when we are analysing inflation would still tell you that you should not yet declare this episode complete even though we have now had a couple of quarters of better CPI data. So we wanted to say that it is too soon, if you like, to declare victory yet and that there are still some forces around that give us pause for thought. We

have to be very watchful on those. I think that most people have understood what we intended to say there fairly clearly. I do not have any particular problems with the bulk of the commentary and no particular comment or issue with the market pricing at the moment.

Dr EMERSON—In relation to the developments over the next six, eight or 10 months where this vital data will come in, the June quarter CPI figure would come out in early August we would expect. There will be other partial indicators, but you will be closely monitoring that. If the circumstances are as you have described in part that these upward pressures on inflation are still there, would the Reserve Bank in that time frame be prepared to make a further adjustment in monetary policy or would you be sensitive to the fact that 2007 was an election year?

Mr Stevens—There seems to be a view abroad that there is some almost unspoken tradition that we do not adjust rates in an election year. I have seen a number of references to my predecessor supposedly having said that. I do not recall that he did say that. What I can recall is that he said we would not be all that keen to be changing them in the election campaign. I know that the political process often talks about being in permanent campaign mode, but what I think he meant by that was the formal campaign in the month prior. He also said if it had to be done it would be. So I do not accept, and I do not think we ever could accept, the idea that in an election year—which, after all, is one year out of three—you cannot change interest rates. When you think about that, I do not think any central bank could accept the notion that somehow a rate change is off limits for one year out of three. That would be crazy. So the answer to the question is: if in August it needs to be done it will be done.

Dr EMERSON—I want to turn to fiscal policy. The MYEFO projects underlying cash surpluses at around $10 billion, or one per cent of GDP. What would you regard as a prudent surplus? Obviously you know what I mean by 'prudent'—that is, one that is such that fiscal policy is not working against monetary policy in seeking to achieve your objectives in relation to inflation.

Mr Stevens—I would be very reluctant to announce some sort of numerical target for the budget surplus. My business is sticking to an inflation target. My predecessor said many times in response to questions on fiscal policy that budgetary policy had not complicated the conduct of monetary policy in his term. And I think—only six months in, admittedly—I would still say that. I do not think the course that fiscal policy is currently on is causing us any great concern, but I do not think it is sensible for me to start to nominate particular numbers. And I think, to be frank with you, what is a proper budget position should be evaluated on a much wider set of criteria than just: does it, or might it, have some small effect on interest rates? There is a whole lot of other criteria that probably are more important, like long-term soundness of the public finances and so on. They are all very important criteria.

Dr EMERSON—And I did not expect you really to put a number on it but to give an answer more or less in line with what you have given. But can I ask whether you consider the current fiscal policy stance to be neutral in terms of not adding to or detracting from the sorts of pressures that you are describing today and in the statement of monetary policy.

Mr Stevens—As published in the budget and I think as updated in the MYEFO, if you do the standard simple calculation that macroeconomists would do, which is to look at the change in the

budget position one year to the next, there is a mild move in the expansionary direction there. It is three-or four-tenths of a percent of GDP—is that right, Malcolm?

Dr Edey—It is a bit higher than that: about half a percent.

Mr Stevens—That is well within the ballpark of what has been seen over a number of years. So it is not unusual—if it is doing anything, it isn't doing anything that it hasn't been doing in the past. The second thing to say there is that my observation over a number of years is that on budget night the calculation of that nature typically gives you an answer something like that, something approaching half a percent of GDP fiscal impact. Then in the September-October of the following year when the figures finally come in, and when no-one is paying attention anymore, what we find is that the swing in the surplus was actually much smaller, if there was any at all, often because the tax revenues have come in a bit stronger and also because some of the spending did not get done. So, ex post, it turned out that a calculation of the budget impact was different enough to what you thought on budget night to give pause for thought because, if you were very activist in response to that budget night calculation—and we have not been—and if you had felt that you should be very actively responsive to that, you could easily have made a mistake because the outcome has turned out to be different to the estimate. That is not a criticism of the forecasters; these things are hard to forecast. But it shows that there is a margin for error in interpretation here that I think is quite important in trying to make an assessment of the impact of fiscal policy.

Dr EMERSON—I think there is a one-in-three exception to that. This is an election year and there will be pressure for the government to spend. No-one in this room knows—I do not think the chairman knows—how much the government is going to spend; he might tell me later if he does.

CHAIR—Sure.

Dr EMERSON—Do you have any comments on the nature of the reduction in the surplus? I just want to go through a number of them.

CHAIR—Bear in mind that other people have questions.

Dr EMERSON—Sure. You could reduce the surplus by giving income tax cuts or increasing family payments, both of which are really a form of consumption behaviour. The third possibility is investing in human capital, which we know is relevant to another topic that we will cover here today—productivity growth. Other options are increased spending on workforce participation measures such as child care or Welfare to Work measures and, finally, increased spending on capital items—capital investment, infrastructure and so on. I am not asking for any quantitative analysis here, but in terms of any reductions in the surplus does the bank have a view on what would be the better or worse options amongst those that I have listed?

Mr Stevens—The general point I would make is that I think it would be a good thing were these decisions to be evaluated on the basis of: is it a good policy or not; is it a good use of money? I am going to try to avoid being drawn on whether I will endorse a particular set of policies or another; that is to be decided in the political realm. But I would certainly agree that

some discussion on the quality of measures, not just what they cost but whether it is worth doing, is a good thing if that can occur. Perhaps I will leave it at that.

Dr EMERSON—I do want to ask about productivity, but later.

Mr KEENAN—I want to ask about the labour market, but first I want to take up the point the chair made before about negative gearing. I know there can be a view that negative gearing can distort people's investment decisions, but what would be the consequences if that were removed for residential property in terms of what would happen to the rental market itself—particularly for people in that market, because it would obviously put an upward squeeze on rents?

Mr Stevens—I do not think it would be sensible for me to start giving opinions or forecasts on fiscal measures. I think that is outside my brief. Most of these tax things have potentially quite complex interrelated effects through a range of markets and I think they have to be thought through very carefully. I cannot answer the question anyway, because it is outside my brief, but I think the question has to be posed in a broader tax effectiveness context. So, I am sorry, but I am not going to hazard a guess on negative gearing or its removal or otherwise.

Mr KEENAN—I will move on to the labour market. The chair alluded before to three per cent unemployment in Western Australia. I have people coming to see me constantly about the shortage of labour, particularly in areas like aged care, fast food, hospitality. Anecdotally, people would tell you that all that labour is flowing into the mining sector, but does the bank have evidence that that is actually the case?

Mr Stevens—There has been strong employment growth in mining. There has also been some quite strong employment growth in construction. That is not surprising because some of that is helping to build up mining infrastructure. We have not done the really fine detailed work on what industries in what regions and in what states. You probably can get data on that, but the thing to remember is that they are very small samples so the statistical reliability of the inferences you might draw tends to diminish. I do not think there is any doubt that, in general terms, there is some flow of labour into the west, and into not only the mining sector but also the sectors which support mining, be that construction, engineering, consulting or those sectors that provide ancillary support for mining, not all of which are necessarily located in Western Australia. Some of them are located in the east. Indeed, some of that very strong demand growth out of the west is actually satisfied from the east, which is why the differences in growth of demand overstate the differences in actual performance.

Mr KEENAN—Assuming that labour is flowing into the mining sector, what effect is that having on other sectors of the economy, particularly on wages demand in other sectors?

Mr Stevens—You would expect that if the draw towards the resource sectors and the sectors which supply the resource sector is strong then that will tighten the labour market generally in other industries. I think that probably is happening. There are plenty of anecdotes to that effect. Labour markets generally are fairly tight. There are few industries, I think, who would tell you that they have plenty of labour and no problem. Most industries would tell you that it is hard to get people. Of course they would; the unemployment rate is 4½ per cent.

If the question, though, is how much pressure rising wages in mining is putting on wages elsewhere—presumably there is some—what is striking when you look through the wage by industry figures is that the differences across industries are fairly pronounced. We are not getting today what we might once have gotten had we had a shock like this—the late 1970s resource boom or earlier occasions. On those occasions, the strong sectors would get a big pay rise and, through the centralised wage setting system, that would flow through to everybody else, through the Arbitration Commission. That does not happen any more. What is happening is that by and large relative wages are shifting. That is encouraging labour resources to move in a way to balance the shock. Yes, there is some pressure on other areas. That is partly because mining is so strong but it is partly because the overall economy has had such a long period of growth, and we had a tight labour market to begin with. But I think the system is handling those pressures pretty well by historical standards.

Mr KEENAN—That is, I suppose, what I was getting at. With such a low level of unemployment and such a tight labour market you would expect wages growth to be higher than average. But we have not had an explosion of wages growth throughout the economy. What do you think the moderating factors are?

Mr Stevens—It is certainly true that we have not had an explosion. We have had some pick-up. The evidence is a little mixed. The wage price index, which is the main official series that gets used these days, has picked up but that pick-up was about a year ago, maybe a little more now, and it has not picked up any further to date. That comment is subject to the December quarter figure coming out later today. Other information from business surveys and so on does show some further pick-up in recent times and certainly business commentary is to that effect. The evidence is not entirely consistent here but, overall, so far, I would say—and I have said this publicly before—that the behaviour of aggregate wages has been quite well contained given the source of pressures that we face.

Why is that? I think there are probably a few things at work. As I alluded to before, the fact that the system is less centralised means that industry or regional pressures do not flow over 100 per cent to other areas. A more enterprise focused set of labour market arrangements is also conducive to better outcomes. I think also that much better anchored expectations of inflation on the part of wage earners are also helpful in these episodes. If you think back to the mid-1970s, there was a very high rate of background inflation that was tending to give impetus to wage claims in a way that does not happen any more because inflation is so much better controlled now. It is our job, of course, to make sure that that continues to be the case. So there are a whole range of things at work to produce what to date has been a pretty good outcome.

Mr KEENAN—Could I just ask about where you see the labour market going. The committee was briefed—and I have seen some analysts say similar sorts of things—that the demand for labour is going to ease. Would the bank share that view?

Mr Stevens—It may ease in some areas as in some parts the pace of growth comes off, but if you look at vacancy data or data on employment intentions out of surveys, there does not appear to be a big signal of impending slowdown in the labour market in the near term. They are probably only useful as near-term indicators. In the longer term, if you like, I could get Malcolm to talk about the details of the forecast that we put together. If non-farm GDP growth is going to be at about trend it would be hard to see a dramatic rise in unemployment coming out of that.

There may be a little bit of a rise—I am not sure—but I think these trends are likely to be fairly moderate. Do you want to add any details, Malcolm?

Dr Edey—It is correct to say that the short-term indicators are still all saying that demand for labour is very strong. When we try and forecast this, the main difficulty we face is that we cannot fully explain why employment has grown as fast as it has in the recent past given GDP growth. This is the productivity puzzle that I am sure we will come back to later. Employment has probably been growing more strongly than we would have expected given GDP. In the forecasts, we expect those two variables to come back to a more normal configuration. So GDP growth will be faster than it has been recently, employment growth will be slower than it has been recently and productivity will come back to a more normal growth rate. That is the best forecast we can come up with. That sort of forecast would imply a small rise in the unemployment rate from here, but it will still stay very low.

CHAIR—We have had questions from the two growth states—Dr Emerson from Queensland and Michael Keenan from Western Australia; he is the only Western Australian in our group—and now to Newcastle with Sharon Grierson.

Ms GRIERSON—In your opening statement today you stated that the trend in corporate leverage bears watching. You also state that there is an appetite for risk that is strong. How much consideration is currently being given by the Reserve Bank to asset prices, the degree of corporate leverage and the growth of debt financed acquisitions as a risk factor for our economic stability?

Mr Stevens—We pay a good deal of attention to financial trends, and it is very important that we do. Asset prices are a key feature of our analytical work on the economy. By 'asset prices' we are talking about the full gamut. House prices, of course, have been prominent over recent years. Share prices are quite high, though gauged by simple but reasonably good metrics, like price earnings ratios, earnings have risen a lot. So share prices in Australia are reasonably fully priced, one would say, but it would be, on a price earnings basis, hard to say that they are grossly overpriced. That is a feature that is common around the world.

On the leveraged buyouts, as you know I have said one or two things about those in public, but I myself feel that this trend may well have quite some way to go. The reason I think that is that the fundamental drivers are a sense that equity returns are good and stable—and that has been the historical fact over recent years—and the fact that cost of debt is unusually low, or it seems unusually low compared with the historical period that most of us have as our formative background. I think it was inevitable that, before too long, some smart people would say, 'If firm profits are good and steady and debt costs are low, it could well be pretty smart to be leveraged.' I think that a considerable part of what is going on in the buyouts and so on is basically a decision to be more leveraged. It is not the only factor in people's minds, but I think it is an important one.

I suspect that while ever that configuration of equity returns and debt returns remains the case—and I think we have probably got a chart in the statement on this—and in the absence of some major event which makes people start to think differently, this trend is likely to keep going. How much of a risk is it? To date, as I said earlier, corporate leverage has actually been unusually low in Australia through the past decade or more. So I do not think, at an aggregate

level, we could stand up on our soapbox and start preaching about excessive leverage in the near term. The thing is that these trends have a habit of starting on some well-based fundamental and, at some point, getting carried along by their own momentum. Most fads, manias, bubbles—or whatever word you want to use—start with something fundamental and, at some point along the way, they lose track of that fundamental. But I do not think you could say that about this trend at the moment.

If that trend does continue and corporates get a fair bit more leveraged, it is similar to households being more leveraged. It means that, in the event of an adverse shock to income, life gets harder quite quickly, and they have to have a strong behavioural response to that by cutting back. That, of course, is the risk with higher leverage. The story is not that different from the households. We never thought that rising household debt itself would bring the economy down. What we thought was that were there to be an adverse shock from somewhere else a more leveraged household sector would exacerbate a downturn. I think that long experience of corporate leverage tells you a similar thing; but we are not really at levels of corporate leverage at the moment where you could ring that alarm bell. What I am saying is: if I am right that this trend has some time to run, it will be one that we will want to watch carefully as it unfolds.

Ms GRIERSON—But some people have been on their soapbox, and I think the Treasurer compared the current situation with the late 1980s. Do you think that was extreme?

Mr Stevens—I am not going to offer a commentary on things that—

Ms GRIERSON—You disappoint me!

Mr Stevens—the Treasurer might say. What I am saying is that it is important to understand the drivers here, and I think it is important to understand that we may be in the early part of what could turn out to be quite a profound trend.

Ms GRIERSON—But at this stage you are confident we do not have a bubble, even though share prices, just as in the late eighties, have increased by 18 per cent and there is over 20 per cent growth in corporate financing.

Mr Stevens—No. I think it would be a stretch to call the share market a bubble based on common metrics like the relationship between price and earnings. Ric, do you want to add anything on share valuations and so on?

Mr Battellino—We have had four years in a row now of very strong returns on shares, but basically all of that has been underpinned by very strong growth in profits. So, over that period, the price-earnings ratio has actually declined. This has been an extraordinarily favourable period for the corporate sector, and that is reflected in the share market.

Ms GRIERSON—So you think asset price valuation is fair and share price valuation at the moment is quite fair?

Mr Battellino—Well, the current PE ratio is not far from its long-run average—so, on that basis, yes.

Ms GRIERSON—Thank you. Just going back to productivity growth, we do have negative productivity at the moment. Is there a case then for maintaining greater productivity growth for further economic reforms?

Mr Stevens—Maybe I should begin by trying to be clear on what the relevant facts are. It is true that if you do the sum that I think you are referring to, comparing GDP growth and employment growth over the past year just on a heads basis, you get a negative answer. Of course, over short periods, productivity is not an easy thing to measure, and that short-run relationship can have a lot of slack. So I would be wary of drawing strong conclusions based on that snapshot. Having said that, there are quite careful measures of productivity which can be made over longer periods, and they certainly do, on the face of it, suggest a slowdown.

There are figures here that I think are probably worth recording. If you take the market sector of the economy, this is the part of the economy for which we can actually measure the inputs and the outputs independently. In some parts of the economy, we measure the output by measuring the input. That is not going to give you a very reliable steer to productivity, almost by definition. But in the part of the economy for which you can do a good measurement—the market sector—for about 13 or 14 years up to 2004 the rate of growth was 2.6 per cent a year on average. It was quite volatile year to year, but that was the average. Since then—and it has only been a two- or three-year period since then, and even that is a shortish period to be drawing a trend from—the trend rate of growth has been 0.9 per cent. That is quite a slowdown.

There are a couple of industries in which there has been a very large measured fall in productivity, mining being one and utilities another. There may be temporary special factors that you can point to there, and you could argue that they should be taken out. If you do take them out, the remaining slowdown in productivity is not as big but it is still not trivial; it is still quite noticeable. Why has that occurred? To be very honest with you, there are maybe a dozen hypotheses around that I have heard, some of which sound superficially plausible but do not seem to me, intuitively, to be likely to be quantitatively enough. Some of them do not even sound all that plausible in the beginning. So we are left with a group of stories as to why it has happened, some of which might be right, but it is very hard to know. Unfortunately, a bit of a puzzle remains as to what is going on.

I do not have a detailed policy prescription for what one does. Historically what we have found is that an economy which is liberalised, competitive, open to the world, and all those things—and I think to open up has been a long-running trend over 20 years at least—provides the general framework that is most likely to foster the innovation, the investment and the efforts that are needed to keep productivity rising.

Ms GRIERSON—I find that that answer does not satisfy for me the constraints that are holding back productivity growth at the moment or suggest some directions you would like to see taken to try to reduce those capacity constraints.

Mr Stevens—I do not really equate capacity constraints per se with productivity slowing down. No doubt there is some relationship in some areas, but conceptually they are a bit different. I think in the mining sector it probably is the case that capacity constraints—and actually the efforts to bring on new capacity, which often mean you have to shut down what you

are doing at the moment while you integrate new bits of production and transport capability—will be resolved and there will be a rise in capacity in those areas.

There will be an improvement in the capacity of the economy to produce in a range of areas because of, I think, the high levels of investment that are occurring. These things take time to occur. When they have been completed, some of the capacity constraints will begin to lift. I think we will probably see that over the next few years. It is frustrating how long it takes, but that is just the way it is. Whether that will mean that measured productivity growth across all these sectors again speeds up to where it used to be, well, I hope so. I am not sure that I could be 100 per cent confident that it is simply a capacity issue. There is no doubt some component of that but—

Ms GRIERSON—What about capacity in terms of the labour market?

Mr Stevens—I think by and large the labour market is functioning quite well. The question is how you make incremental improvements to that into the future. I think all this stuff is long-run, grinding, incremental improvements. They are made by businesses, of course. By and large governments cannot create productivity; all they can do is make sure that the overall environment is not somehow inadvertently impeding it. It is the businesspeople and their employees who actually do the things that are needed to get the productivity. That is no easy task and it is a kind of relentless, grinding process. But other countries do it. I do not see any reason why our businesspeople and employees cannot.

CHAIR—Thank you very much. With a question from the Gold Coast, we now welcome Mr Ciobo.

Mr CIOBO—If I were to summarise what I have been hearing from you, it would be that things are going reasonably well but there is still some significant risk, with inflation predicted to remain relatively high. That picks up on the questions from the chair. Would it be correct to say, from a governmental point of view, that we have things going pretty well economically but that it is also going to require a certain amount of discipline and financial management going forward? I think your predecessor said that if surplus budgets remain between one and 1½ per cent of GDP that will not produce undue stimulus to the economy. Therefore, from a government point of view, should disciplined economic management, disciplined spending and not seeing an artificial increase in wages mean that that upward risk from inflation should remain subdued?

Mr Stevens—I think disciplined policies in the government area from any government are always important. They always have been and always will be. I suppose you could say that the inflation assessment that I gave you earlier is predicated on a range of assumptions, one of which would be that budgetary decisions in the Commonwealth and in the states do not lead to any untoward pressures one way or the other in the economy.

Mr CIOBO—So I take it that increased spending and deficit budgets would fall outside of what we are now talking about?

Mr Stevens—I think you cannot make a blanket statement that this size of surplus is good or that this size of deficit would be bad. You have to frame these things against the background of what else is going on. For example, if the economy were to enter a very deep slowdown—and

some day it will—the budgets will all go to deficit just like that. Will that be inappropriate? I would not have said so in those circumstances. In circumstances where the economy was already overheating and inflating, a massive move towards a budget deficit would probably be not the right direction.

Mr CIOBO—With regard to some of your introductory comments where you draw the link between the size of the labour force and the rate of economic growth, my understanding from your comments is that there is a direct link there and that essentially if the labour force is at capacity, the rate of growth is required to be slower. Given that we have seen a lot of evidence—and this committee has certainly heard it anecdotally as well as in direct testimony—that there is a great requirement for skilled offshore workers to come into Australia, does this in some way help to ensure that we can maintain a higher rate of growth? If we were to see a cut-off or a stop of the importation of that skilled labour, is that likely to have an impact on wages growth, on inflation and consequently on interest rates?

Mr Stevens—I am not sure that I want to draw a direct connection between immigration and interest rates. No doubt, in some areas at least, the ability to tap offshore skills in the short term is helpful. This in a way harks back to the old debate over whether immigrants raise unemployment or not. The answer that the best experts always gave was: 'Immigrants create as many jobs as they take.' In other words, they add to supply but they also add to demand. You have to house them as well as employ them. What is the net effect of that on the rate of interest? It is a pretty complex question that I do not think I would try to answer off the top of my head. A higher population growth in time obviously means that the absolute rate of GDP growth is probably going to be somewhat higher, assuming that the rate at which those people bring skills and can acquire their own skills is not that different to the domestic population. If per capita GDP growth could be more or less the same, the total will be higher if the population growth is higher. I think the question would be how you get to that longer-run equilibrium and what stresses and strains might occur in the interim.

Mr CIOBO—I would have thought that it is not an obtuse proposition when, as we are talking about, you have labour market at capacity—or certainly near capacity—that the offshore supply of additional labour would be a soothing factor, so to speak.

Mr Stevens—It would be a soothing factor for the people who employed those workers.

Mr CIOBO—Sure.

Mr Stevens—And presumably there is more demand there for the people who had to build the houses that those workers live in if we have added to the population. You have got differing effects depending on what part of the economy you are talking about.

Mr CIOBO—Dr Edey, you mentioned that employment has been growing more strongly than expected given GDP growth. If all factors are taken to be equal from a historical point of view, is it possible that we are now seeing employment growth higher than expected given GDP growth due to policy changes?

Dr Edey—I do not think we can say what is driving it. The fact is that if you try to line up GDP and employment from quarter to quarter or from year to year, sometimes they roughly line

up and sometimes they blip around and you cannot really explain the blips. At the moment employment is growing by three per cent per annum and non-farm GDP is 2.6 per cent. That does not seem to line up. It is part of the general productivity puzzle we have been going through.

Mr CIOBO—I understand you say you cannot determine what is driving it, but I take it from your evidence that you can say that economic growth is not driving it.

Dr Edey—Economic growth is driving some of the employment growth. The fact that we have had a slowing in productivity growth is telling you that there is some employment growth happening that is not explained by the average relationship we have had in the past between GDP and employment.

Mr CIOBO—Governor, I turn to some comments that you made with regard to state governments. Specifically, you said:

Governments in several states, conscious of the need for public infrastructure, are also looking to expand investment. There appears to be considerable competition for the resources needed to complete all these projects.

Certainly your predecessor raised with this committee in previous testimony some concern over the fact that a large number of state governments are running deficit budgets. Your comments to me appear to, if not pick up on this, run parallel with those concerns. That is, we are seeing significant deficit budgets and expansion at a state government level pushing up costs and potentially driving up interest rates. Is that a fair conclusion?

Mr Stevens—What I am saying is that there is, at least as announced by the state governments collectively, the intention to considerably expand spending on capital type things this year and a bit more in the coming financial year. I am not saying that those projects should not be done. It is not for me to evaluate. I am just noting that, at a time when the private sector is also doing a considerable amount of investment of a similar nature, it is probably going to be hard to get the labour and capital resources you need to complete the projects. It is not that they cannot raise the money. Raising the money will be the easy part. Finding the real resources to do the work could be difficult. It is their call; it is their responsibility, but from where we sit we think it may be hard to find those real resources in the near term.

Mr CIOBO—So generally in a competition for scarce resources, you see a greater willingness and desire to spend more to obtain those scarce resources—

Mr Stevens—I am not sure whether the response will be to just spend more and more to get the resources or whether some of the projects would be deferred. That would be their decision to make, and it is their responsibility; but in that part of the economy there are not many spare resources to do this work.

Mr CIOBO—Finally, I want to touch on some comments that were made by your predecessor. In his testimony in August last year in Sydney, he said:

I think there is an issue which state governments probably will have to look at: are the land release policies, the front-loading of all the charges, the right set of policies? … I think there is increasing attention now being focused on that.

That was in response to questions that I had about housing costs, the lack of release of greenfield sites and the additional state and local government charges. Further to that, the residential development cost benchmarking study that was put forward by the Property Council in April 2006 showed that, for example, total infrastructure levies in Sydney were at $68,233 per lot, in Melbourne they were $7,848, and in Brisbane they were $16,701. The total infrastructure charges per lot for new housing developments in Sydney were up 466 per cent between 1995 and 2006. They were up 279 per cent over the same period in Brisbane and up 40 per cent in Melbourne. Given that construction costs have increased by only 38 per cent over the same period, is it reasonable, given these profound increases in infrastructure charges and levies at state government and local government level, to expect that this is having an upward impact on inflation and therefore is putting pressure on interest rates as well?

Mr Stevens—As you say, these charges have risen considerably. This is because, as I understand it, instead of having the community bear the costs of all the associated infrastructure and pay it off over a long period, the current policy in a number of areas is that the homeowner takes that on their balance sheet instead. Does that add to the cost to the private sector of adding to the stock of dwellings? Yes, it must. How big a contribution that makes to the overall rise in property values is another question. It is presumably making some contribution but, as you know—we have talked about this on many other occasions—other factors have also been at work.

What we are talking about here is the marginal cost of adding to the stock of dwellings. We need to add stock somewhere, every year, to house the additional population. If you are worried about the marginal cost of that to the private sector then, yes, these questions about whether those charges are appropriate come up. If you decided they were inappropriate, those costs would still have to be borne by somebody. There would be a lot of questions about whether the taxpayer should take all those costs on as well, if that was the alternative.

My predecessor talked about when he was young and the kind of house they built and lived in on the outskirts of Melbourne. Those were the days when you had a fibro home with an outside toilet. I doubt that you could build that in any city anymore. It would be very cheap if you could, but you cannot because society's standards these days are more that it should be a four-bedroom, brick-and-tile house with a double garage or whatever.

CHAIR—Certainly not in Sylvania Waters.

Mr Stevens—Chair, I will let that go!

Dr EMERSON—Are you telling me the governor does not live in a fibro house?

Mr Stevens—My house is not a fibro house, but it is a piece of spec rubbish, built in the 1970s, and in many respects it shows that. Anyhow, the standards that we have collectively set mean that you cannot make very low-cost additions to the stock. Is that a good thing or a bad thing? I think opinions on that would vary. These are all complex issues but, if the focus is on the marginal cost of adding to the dwelling stock, all this stuff is certainly relevant. But you have to work out who is going to bear the cost.

CHAIR—Before we pause for our break, we have two groups of students here, from St Mary's Anglican Girls School at Karrinyup and Carmel School at Dianella, who have the opportunity to ask questions now and at the end of the session. We will have a question now from a student from St Mary's Anglican Girls School.

Sarah Paterniti—Mr Stevens, if the drought worsens, how big an impact do you think this could have on the CPI and could it influence decision making on interest rates?

CHAIR—That is a good question.

Mr Stevens—Yes, it is a good question: what is the effect of the drought on the CPI? We have addressed this in our published statement—I think the November one had some material on this. It turns out that usually in a drought some prices rise because there is less supply of some products, but some prices fall. One area that that happens is meat. If the farmers cannot feed the cattle they tend to send them to slaughter earlier and so meat prices can decline. On a net basis, the effects of droughts typically have not been systematically one way or the other in the past. So the first attempt at answering the question of what effect there would be on the CPI if the drought worsens is: maybe not that big an effect. In any event, if it is just a temporary rise in food prices or a temporary fall, we would not change interest rates in response to that. We did not change interest rates in response to bananas, for example. That was another climatic event that happened. We would look through that, as we say; we would anticipate that it is a temporary thing, and monetary policy usually does not respond to temporary fluctuations, if there are any. But it is not clear that there would be anyway in the drought case. That is as good as I can do.

CHAIR—We will take a break now.

Proceedings suspended from 9.36 am to 10.00 am

CHAIR—We will return to questions. I have a question on the basis of information that has just come through on the wage price index figure of 1.1 per cent, making it four per cent for the year, which is higher than expected. In view of the comments that were made earlier, I wonder whether you would like to comment on that and the implications for the economy and inflation figures.

Dr Edey—Obviously I have not had a lot of time to study the figure. As you say, the main figure was an increase in wages of 1.1 per cent in the December quarter. If we look over the recent sequence of numbers, we had a lower figure for the September quarter, of 0.8 per cent and prior to that the sorts of numbers we were getting were around the one per cent mark over the previous few quarters: there were some 1.1s there, 0.9s—numbers like that. So the latest number is towards the high end of the range of recent readings we have had but not outside that range.

I should just make a point of caution in interpreting the recent numbers. The change to the minimum wage setting arrangements has meant that the sequence of wage figures we are going to be seeing for a little while now will have a different seasonal pattern to the pattern that we have had in earlier years. The effect of that in the September quarter was to reduce the rate of increase in wages recorded in the index, so we have to keep in mind that that figure is distorted by that effect. The December figure for the increase should be largely undistorted by that effect

because most of the Fair Pay Commission's decision will flow through in the March quarter. So 1.1 per cent is probably an undistorted figure for what happened in the quarter, and, as I said, it is at the upper end of the range that we have had in recent years but not outside that range.

CHAIR—Fine.

Mr TANNER—I come from the boom state of Victoria. You will note in the statement, in table 9, that last year's employment growth in Victoria was stronger than Western Australia's, which is an interesting lead-in to the primary question I want to ask, which is about the spin-off effects on employment of the mining boom and to some extent related to the puzzle of GDP rates versus employment rates. This may be a question for Dr Edey or for the governor; I am not sure. To what extent do you think the minerals boom is actually contributing to the strong employment growth that is occurring in most of Australia? There was a very good article by David Uren—who is here today—in the *Australian* a couple of days ago where he pointed out that a lot of the money that is being generated by the minerals boom will actually end up in other states through increased share prices, company tax and, of course, purchases of goods and services that are produced in those states. Given that rather interesting figure for the previous year, up to January this year, where employment growth in Victoria was higher than it was in Western Australia, is that an indicator that what we are effectively seeing in the strong employment growth—unusually strong relative to GDP—is largely a wider spin-off of the minerals boom?

Mr Stevens—There are actually two questions in there. One is: is there a flow-on from the minerals boom and all that is associated with it to the other parts of the country? The answer to that is yes. That is why, as I said before, when people look at the rate of demand growth in the west and they compare that with other states, those differences are quite stark, but the real differences in underlying economic activity are not as big as that because of these flowovers. Some of that demand is filled from the east; some of it is filled from abroad as well. So to the question: are there spillovers? Absolutely. They are through higher incomes for shareholders and employees; that feeds into demand and that spreads around the country. Some of that higher income of course is owned by foreign investors because some foreigners have some ownership of the share market, so they get that bit, and that shows up in the balance of payments. But a good deal of it stays at home for shareholders and workers here, and governments get some, as you say.

The second question is whether the resource boom and its effects around the country explain the productivity puzzle. I think a plausible case can be made that the very large measured decline in mining productivity—not just a slowdown in growth but an absolute decline, which is very large—leaving the difficulties of measurement aside, no doubt has a lot to do with the efforts to expand capacity, and the temporary disruptions to production that come with that, and you do not slash your workforce while those things are happening. So probably that is a big part of the story there. But whether the income effects of the resource boom, as they affect output and employment in other states and other regions, are an explanation for the apparent productivity puzzle, I am less sure about. I do not think that is obvious. Malcolm, do you want to add something there?

Dr Edey—To get that effect, you would have to explain why the spillover generates employment without generating output. What you can explain is that the spillover generates a

whole lot of extra expenditure, but that should be generating both output and employment, so I do not think that is really an explanation for the productivity puzzle. Interestingly, if you look at the statistics for just the extra employment in the mining and construction industries in Queensland and Western Australia, which is where you should expect all of this additional employment to be concentrated, you will see it is only about one sixth of the overall national employment growth over the last couple of years. That is a greater contribution than normal and it is contributing to the overall story, but it is not the whole story by any means.

Mr TANNER—Might part of the explanation be that internal sectors are higher than you might anticipate and that a proportion of the spillover is heading into non-market activities—for example, government expenditure—which will not show up in productivity figures so, in relative terms, they may be pumping up employment more than output? Is that underlying change in the structure of activity potentially an explanation for it?

Dr Edey—I think that could contribute to it in principle but, if you are going to go down that route of trying to explain productivity by these changes in the composition of growth, you have to do that across the whole economy. We published some analysis on that in the November quarterly statement. That showed that the shifts in the composition of employment across industries are actually going in a direction that should be adding to productivity growth—not by very much—but it goes in the wrong direction to explain what we are trying to explain. For example, if you think about the level of productivity in the mining industry, in absolute terms it is much higher than it is in the rest of the economy. So, when you draw more people into the mining industry, the compositional effect adds to overall productivity, even though it reduces productivity within the mining industry. And, once you try to allow for all of those effects and quantify all of that, the net contribution you can get is not very big.

Mr TANNER—Finally, with respect to inflation risk, towards the end of your written statement, Governor, there is a sentence which states:

So there would be some risk of inflation remaining uncomfortably high were demand growth to be unexpectedly strong in the near term.

Is that code for: 'Don't go spending up big in an election year?'

Mr Stevens—The outcome for inflation that we have written into the forecast is predicated on a number of other things that are occurring, one of which is that domestic demand growth is a pretty moderate trend or below trend. Were there to be a surge of demand from whatever source—it could be public sector but it could be private sector—it would pose a question as to whether demand might not be considerably stronger than assumed and that might affect the outcome for inflation. That is all it is saying. It is not code for that in particular; or, if it is, it is also code to the private sector to not go spending up. It is not meant to be aimed at anybody in particular. It is just a statement of risks.

Mr SOMLYAY—The Reserve Bank often describes interest rates as being expansionary, contractionary or neutral. At our last hearing in Sydney, when I asked your predecessor where he would place interest rates then, I think he said, 'The upper end of neutral.' Now that we have had a couple of movements since then, where would you place interest rates right now?

Mr Stevens—We have had one movement since August. I would say, and we have said, that we regard policy as being mildly on the restrictive side of neutral—mildly; not all that much but a bit. If you compared the cash rate to its average, or that sort of thing, that would be the answer you would come up with. In the economy in its current circumstances that seems to us to be the appropriate side of the neutral position to be on.

Ms BIRD—I want to explore a statement in the December Mid-Year Economic and Fiscal Outlook about risks and uncertainties. It identifies the speed and extent to which households respond to interest rate rises. It would seem to me that over the last 10 years the structure of household finances has altered quite significantly in that wages, government payments and the availability of credit options have given a range of income streams into households. I am interested in your observation about how responsive you think households are to those rate rises—is it sustained or does it drop off and they need to be reminded again? I am interested in your perspective on that.

Mr Stevens—That is quite an important question. There is no doubt that, for those households which are more leveraged now, a one-quarter per cent rate rise, which is the common size of moves we make these days, has a noticeable impact. If you go back to, say, the end of the 1980s or even the middle of the 1990s it was quite routine to move rates by 100 basis points at a time. I think there would be some shock around the place were we to do that these days. The higher leverage means that those households who are in debt are facing a more direct constraint on their cash flow than they once did for any given size of rate move. In a sense we respond to that by calibrating the size of moves differently. It is a remarkable world to be in when you consider our history. We are now making quarter-point rate moves and it is a big deal—is there one or isn't there? There have been a handful of them over several years and that is regarded as highly significant. Think back to days when much larger moves were routinely made and people hardly noticed that they had occurred. So there is that higher responsiveness and, as I say, we calibrate the size of the adjustment accordingly.

As for whether people need to be reminded, I take it you mean do we need to keep delivering dollops of the medicine in order to keep getting the effect, and I am not sure that we do. What I have always said is that it is the changes in rates that make the news but it is the level they get to that actually does the work. Doubtless there is an initial confidence impact of the move itself, but in most gauges of confidence that are available that is pretty temporary; it is not persistent at all. However, the change in people's cash flow position, the change in an asset price, the change in how feasible it is to finance some piece of expenditure using borrowed money—that does persist as long as the level of rate stays in the place you put it.

So we tend to ask ourselves not so much, 'Do we need to keep delivering changes to get the effect on behaviour that we are looking for?' but rather, 'Is the level that we're at going to give us, cumulatively, the effect on behaviour that's needed?' And that effect, of course, takes quite a long time to come through, which is why I said earlier that, in forming our judgement about consumer behaviour and house building over the coming year or two, we are keeping in mind that the full effects of what we have done are not here yet; they are continuing to come through the economy. So it takes a while. But we tend to think, 'Is the level of rates at the correct place to give us the cumulative impact that seems to be needed?'

Ms BIRD—So, Governor, can I take it from that, when you say that you are not sure that the full effects have come through yet, that you are not presuming that that would be a braking effect on the expenditure?

Mr Stevens—There has been some effect already, and I think we can see that if we look at, say, loan approvals just for housing. That is one place where this shows up quite quickly. I think you can see an impact already. My point is that I do not think you can assume that that is the total impact. The research work on this stuff historically, for what that is worth, tended to show—Malcolm will correct me if I get this wrong—that the mean lag in the modelling was always about 18 months, I think. Is that right?

Dr Edey—Yes.

Mr Stevens—What that means is that half the ultimate effect has occurred after 18 months. The other half is still to come. So monetary policy has long lags and that is why we have to be forward looking when we implement it. So I would not say there has been no braking effect so far. I would say there has been some braking effect but not all the braking effect: some of it is still ahead.

Ms BIRD—I have a second question, Chair. There is a lot of talk about the two-speed economy geographically, but, coming from New South Wales, I do not think that is too surprising. I think there is also a two-speed economy in terms of existing long-term homeowners—those in the market who see their asset values have increased and feel confidence because of that—and new entrants and renters. How do you factor that in in terms of your responses about interest rates and their effect on the two very different groups that have developed?

Mr Stevens—You have put your finger on a very important distinction in the housing market. The 'crises' that we keep reading about are basically the problems of people who would like to be in the housing market but are not there yet. People worry greatly about affordability for those people and whether interest rates rises might make that affordability more difficult. But the real problem for those people is not that the rate of interest is high. We could argue about 25 or 50 points here or there but, by and large, interest rates today by historical standards, for those of us who remember earlier times, are low. The real problem is that house values are so high. Frankly, if one is really concerned about aspiring entrants to the home market, what you really want is lower prices.

For renters, the equation is a little different, but, again, as I was saying earlier, the rental yield is very low. A big reason for why that has occurred is that the capital value of these properties is so high. If you were deciding whether or not to take ownership of a property as an investor and looking at what your return would be, it is a very low number because the entry cost of that asset is so high. I am oversimplifying a bit, but these very high home prices are a problem for those particular parts of the home market. As you say, those of us who are fortunate enough to already have a home feel more wealthy, but there is this other group of people who see the prospect of that receding as prices rise.

Ms BIRD—Can I just clarify that you are not indicating that cheaply available credit has not influenced asset prices?

Mr Stevens—It does. I would not deny that for a moment. In fact, we have said that one of the big factors for why house prices rose a lot in the latter part of the nineties and into the early part of this decade was that interest rates were very low. They were very low because inflation was low. The rough statistic that I have quoted many times was that the average rate of interest was about half; that meant you could service twice as big a debt. Guess what? That is exactly what occurred, and that had a very profound effect on asset values. It is not the only thing at work. Some of the other things that we referred to earlier have also been important, but low interest rates do encourage higher borrowing and they have encouraged higher house prices. I do not think there is any resiling from that.

Mr SECKER—In your opening statement you said that a wide array of business enterprises the banks talk to have been saying for some time that it is harder and more costly to find appropriate staff and that the factor most constraining further expansion is not insufficient demand but insufficient capacity of either labour or capital, or both. How long would you say that effect has been around? Would you expect this constraint of capacity to reduce inflation? What other effects might it have?

Mr Stevens—It has been around for a while. We started talking about capacity constraints in the economy a few years ago now. I know that on occasion people wondered what our evidence for that was, but we did not make it up. This was what business had been telling us—quietly initially and then with increasing volume—for some time. It is what you expect to have, actually, in an economy which has had a long period of growth and has now used up most of the spare resources. There is a very good illustration of that on page 53 of the statement. Graph 75 is from the National Australia Bank survey where they ask people, 'What is the factor most constraining output?' You can see that for a long time not enough demand was the big factor, but for two or three years now that has been eclipsed by the availability of labour. It has been around for a while and it has been part of the main story that we have had. We felt the economy was a bit more prone to inflation problems in this period than it had been earlier, and that has turned out to be the case.

How long will it persist? Well, I think there are a couple of components to the alleviation of this issue. By the way, we should say again that to be at full employment—and I would characterise us as pretty fully employed—is a good thing. This is actually what we are supposed to be doing. It brings issues of management, but you do not want to be seriously away from full employment because, apart from the human tragedy of serious unemployment, it is a waste of resources. You do not want to be there; you want to be pretty near to full employment. It is just that, when you are there, you have to be more watchful for inflation.

Going forward, the more moderate pace of growth in the economy that we see today compared to a few years ago will be helping not to put further pressure on capacity. There are higher levels of investment being undertaken by business. It is common here, in discussion about growth prospects, to talk about the rate of growth of investment, but it is actually the level of investment as a share of GDP that we ought to be looking at to ask, 'Is enough investment occurring?' There is a fair bit going on. So that will be adding to capacity. I think, over time, that will increase the economy's supply-side potential and give us the prospect of a nice balance between demand and supply without too much inflation but near-full employment.

Mr SECKER—You also made reference to states and the increase in investment in public infrastructure via state governments, the planned increases. Does the Reserve Bank have any concerns about the effect of this increase in public infrastructure? Many people would say it is a very important thing that we need in Australia. Do you have any concerns about the effects, firstly, with the extra borrowings and demand on money that is occurring as the result of that and, secondly, the possible inflationary effect of the competition for those resources?

Mr Stevens—You say that many people say we need these projects. By and large I would agree with that. I think it is apparent in a number of areas that infrastructure, like anything else in the economy, needs investment. So it is not a question—I do not want to get into endorsing or otherwise particular projects, but it would be generally agreed by most people that infrastructure for investments of various kinds needs to be done.

As I said earlier, I do not think the problem here is finding the money. Balance sheets of governments in this country, by and large, are in very good shape. They will not have any trouble borrowing money from the lenders of the world for a reasonable project. That will not be the problem. The problem, as I said earlier on, will be how you turn the money into the real resources of labour and capital to do the work if the private sector also wants those resources. This is a timing thing. What we are saying is it would appear, at the moment, that that is a hard ask to find those resources. That is all.

How inflationary is that? I do not think it will feed directly into the consumer price index per se, but all of this stuff is part of the picture for demand in the economy that makes up the overall forces that we are trying to assess. That is the situation we face, and what we are saying is that we think, at the current juncture, it is hard to complete these projects. I am not saying they should not be done, but it will be difficult.

Mr SECKER—On a completely different line of questioning than we have had this morning, does the Reserve Bank take a view on the climate change debate—firstly, on carbon trading and, secondly, on carbon taxes and the resulting higher energy costs—and the effect on inflation, employment and interest rates?

CHAIR—Have you done any modelling, unlike the Treasury?

Mr Stevens—It is not our business to have opinions on the climate change issue. It is a very complex issue. One of my board members is an expert in these matters, but it is not a Reserve Bank responsibility so we do not have any view on whether there should be a carbon tax and what its effects would be. We have not done any modelling and it is unlikely any time soon that we will. There are other people who are more expert who have the responsibility to do this.

Mr TANNER—They are refusing, though.

Mr Stevens—I cannot help you there. It is not our business to get involved in that. That is all I can say on that matter.

Mr SECKER—I was not asking you about whether you thought that climate change was important or anything like that; I was wondering whether the Reserve Bank would look at the effects of certain government policies that might occur, such as carbon trading or carbon taxes.

Mr Stevens—If there is a carbon tax at some point that adds to costs, we will make an assessment of that and what if anything it would mean to monetary policy when the time comes. It is one of the myriad of things that might happen that might have some effect, but all we can do about that is wait and see what occurs.

Mr SECKER—Considering that you have said that employment is a very important part of the role of the Reserve Bank and that it is good that we have high employment, would the Reserve Bank take a view on suggestions that we close the coal industry down or other such projects?

Mr Stevens—I do not think that the community will be lacking for informed opinions on whether the coal industry should be closed, so I do not think that they really need one from me. We will not be offering a view on that.

Mr SECKER—Thank you. What conditions would the country need to occur that might suggest to the Reserve Bank that interest rates would need to be reduced? We have talked about possible increases. What would we need to see to have a reduction in interest rates?

Mr Stevens—Reductions in interest rates under our inflation-targeting framework would be associated with an assessment that inflation was going to undershoot the target rather than risk overshooting it. I do not think that those conditions are in place. It is a fair enough question to ask. Let me be clear that we have not given that possibility any thought at this point. It is a bit early to be talking about cuts.

CHAIR—We will have one last question from the panel in this round, and then I will ask the panel members to consider perhaps one question each before we conclude.

Mr McARTHUR—I want to raise the matter of the savings policy and the escalation of household debt and credit card debt, both in terms of the magnitude to which some households are in debt and in terms of their ability to service it. But it is really about the magnitude. If there was a downturn, what would that do to the economy?

Mr Stevens—Your question is about whether household leverage is a risk.

Mr McARTHUR—That is the thrust of the question.

Mr Stevens—You have also referred to savings. What I will do is have a go at the leverage point. Ric has done some work on what has happened to the stock of our savings, and it is quite interesting. We should spend a moment on it. With your permission, I will pass to him in a second. On the question of whether leverage is an issue in a downturn, we have said more than once that a more leveraged household sector means that if there is an adverse shock to their income—let us suppose that there is a global recession and Australia enters a downturn as a result of that, which is not happening and does not look like happening soon but which is conceivable one day—they will find that things will be harder. They would, we expect, be more likely to very sharply cut their consumer expenditure in order to keep their mortgage repayments. That would be the most likely outcome.

In modelling all this sort of thing through the recent stress test scenarios we did with the IMF's financial sector assessment program, that was the kind of thing we were looking at. So a more leveraged economy is an economy which suffers more when there is a loss of income. There is no doubt that is true; that is what higher leverage means. That has been a risk factor, and it is one we have talked about more than once at these hearings in the past. But there is not a great deal we can do about that, other than point out the issue and try to keep people aware of it when they make their decisions.

As to the question about saving and how much saving there actually is, Ric might like to talk about the long-run comparisons we have done here, because it is quite interesting.

Mr Battellino—The measures of household saving that get most attention are the measures that come out of the national accounts. For Australia, they show that household saving is very low and, in fact, even negative at times. In the United States it is a very similar picture: household saving is low or negative. That is one measure of saving.

Another measure of saving is to look directly at how households' net financial assets are growing, because ultimately savings must show up in an accumulation of assets. If you look at it that way, household savings in both Australia and the United States are actually growing very quickly. In fact, in both countries the accumulation of savings by households is even stronger than it is in, say, Europe, which traditionally has been seen as having very high-saving economies. The reason this discrepancy arises is because Australian and US households hold a huge proportion of their wealth in financial assets where the return is coming from capital gains. Basically, they hold their financial assets in the form of equity, and the national accounts deliberately do not pick up capital gains on equities as part of the return.

So the sorts of traditional measures which have been used for a long time are really biased against households in Australia and the US, which tend to be more advanced in some ways in their financial decision making. As Glenn said, when you look at the accumulation of financial assets in Australia and you compare it to, say, household assets in Germany, the Australian households have been accumulating assets much faster than the Germans even. So I do not think it is correct to say that Australian households are behaving irresponsibly or that somehow they are in very poor financial condition. Australian households are actually in very good financial condition. It is just that the traditional measures that are used to measure saving do not really apply to countries like Australia and the United States.

Mr McARTHUR—Can you comment on the credit card debt of certain sections of the community who use that for consumer spending?

Mr Battellino—Credit card debt has been rising. Phil is probably more expert on what has been happening recently. I think it has slowed down since the bank's reforms of a few years back. But the big part of household debt is not to do with credit cards; it is to do with mortgages and other forms of debt. Phil may have something more to say on credit.

Dr Lowe—Credit card debt only accounts for around four per cent of total household debt, so in aggregate it is a very small share. Obviously for some individuals it is their main form of debt, and some of those individuals struggle to pay off their debts, but in aggregate it is only a very small part of the story. Over recent years the arrears rate on credit card debt has moved up very

slightly but still remains quite low. So in aggregate there is not an issue there, although obviously some households do struggle to pay off those debts.

CHAIR—Has there been the shift in terms of the move to Amex and Diners? Has that accelerated or has it remained similar to what it was before?

Dr Lowe—The story has been pretty much unchanged for the last two years. There was a small increase in the market share of American Express and Diners in 2004 and since then the market share has basically moved sideways.

Mr McARTHUR—Could you comment on the USA's indebtedness to the rest of the world in borrowing capital and what impact that might have in a downturn in the US and world economy?

Mr Battellino—There are two ways to look at that. The popular perception is that, somehow or other, the US is out there spending a lot of money and has to go around the world borrowing to fund that expenditure. I am not sure that is the correct interpretation of what is happening. I think that what is really happening is that the investors of the world want to invest in the US financial markets. They are inundating the US with money, and the US economy and US households are responding to those financial pressures.

I am not sure that there is a huge problem of US indebtedness. I think this is really a sign that world investors actually very much value the characteristics of the US financial markets. There is no doubt that they have the deepest, most liquid and most credit-worthy financial markets in the world. People who have excess savings want to put a lot of their money in the US.

Mr McARTHUR—Do you think the breaking of the drought will provide inflationary pressures?

Mr Stevens—I do not think that that will be a significant problem. It will result in more farm produce being available—which, for those products, should lower prices not raise them. It would also increase incomes. When the drought occurred, our conclusion was that it probably was not going to have too much effect on inflation either way. Even if there is a temporary price impact, it should be a temporary one. So, for monetary policy, that should not normally be a big problem.

Mr McARTHUR—My final question is: do you see any restraints in the economy because of lack of water and government policies on the provision of water? In parts of Victoria that is starting to impact on industry and households.

Mr Stevens—I have no comment on the role of government policies on whether there is enough water. There is plenty of commentary from elsewhere on that matter. Water, though, presumably for some parts of the economy—not least the rural sector—is an input, and not having enough of that input must constrain the outputs. I think that follows, and the question will be how one arranges for an adequate supply of that particular input—

Mr McARTHUR—You have done no modelling on the impact of lack of water for metropolitan areas?

Mr Stevens—We have not done modelling on that, no. We have not got a model that would give us the answer to that.

CHAIR—I have a question on the global economy. Are you concerned about the impact for the US economy of the significant downturn in January of 14 per cent in housing starts? In terms of Australia's largest export markets—Japan and China—there is the question of their viability in terms of the attempts by China to slow down growth and also the mooted plan by Japan to put up interest rates.

Mr Stevens—On the US question, there was a big fall on that particular monthly indicator for housing, but, as usual, let me issue a caution to us all on not over interpreting monthly figures. It looks to us at the moment as though the housing construction sector is finding bottom in the US. It has gone down a lot; there is no doubt about that, but it may be finding bottom. Thus far the spillover, such as there has been, to the rest of the economy, has been manageable. At the moment I think we do not have any discomfort with the kind of consensus outlook that is around for the US. They have been growing at or even above trend up until now.

On China, it is true that they are trying to kind of constrain things a little. They are also trying to shift away from such a strong emphasis on investment spending towards more consumer spending. I think that is a welcome change, because even China probably cannot sustain investment approaching 50 per cent of GDP indefinitely. That does not sound likely.

There is always the risk, of course, that they somehow overdo it and the economy goes into a big slowdown. If that occurred, we would certainly notice that here, and so would the rest of the world. I think, for the past 10 years anyway, the authorities up there have done remarkably well managing things, given the rudimentary tools at their disposal. Even if China does have a big slump it will get up and run again pretty quickly because it is just that part of history where they are going to grow to be a very big economy. There will no doubt be a few trips along the way but they will get up and run again.

Things in the private sector in Japan from a business sentiment and financial solvency point of view look better now than they have for quite a long time. That is quite welcome. I think the Bank of Japan is meeting today or tomorrow. I do not know whether they are going to raise rates but what we are talking about here is from 0.25 to 0.5. When they feel they can manage to have normal interest rates again we should welcome that. There is something very strange about a G3 country giving out free money. They are doing it for good reasons of their own but this has an effect on global financial markets that is part of the story of the search for yield and the extremely strong appetite for risk. It is by no means clear that it is a healthy state of affairs to persist.

Dr EMERSON—I would like to go back to the productivity question. You have cited figures of very low productivity growth over the last two or three years. Indeed, in the last six months it has been sharply negative. I know we should not put much emphasis on a six-month productivity growth figure, but is there a problem here? You call it the productivity puzzle. We talk about mining; that is five per cent of GDP only, so something is going on in the other 95 per cent of the economy, presumably, that mining cannot just explain on its own. What are the consequences of an ongoing low rate of productivity growth for the sustainable rate of economic growth and for inflation if we were to have this current situation of very strong demand and capacity

constraints? Do you have any suggestions, for example, for productivity enhancing measures, such as investing in human capital through education and training, that policymakers ought to take on board?

Mr Stevens—I agree with you that it is more than just mining. In the figures I quoted earlier, which took out mining and utilities, you do not get as big a slowdown but still quite a noticeable one. There is still quite a bit to explain, so it is not just mining. Of course, we cannot know whether this trend of a couple of years is now going to be a permanent state of affairs or not. We just cannot know that. If it were—in this hypothetical world—that does mean the economy's potential rate of growth is lower. I do not think that actually means a great deal for inflation in the medium term. If the economy's potential GDP growth is lower and we can work that out, then we just have demand growth correspondingly lower and we keep inflation at two to three per cent. That will occur and there will be some issues in how quickly we can work out what the change is and so on.

The real consequence of persistently lower rates of productivity growth into the long-run future is simply that living standards do not rise as quickly as they might have. One per cent or even half a per cent a year productivity difference accumulated up over a generation is a lot. We will notice the difference as time goes by, so productivity is very important in that long-run structural sense.

I do not think, other than in an initial transition phase, it is particularly a big deal for monetary policy because we will act to keep inflation at two to three per cent with whatever trend productivity growth the economy can deliver. It is really a living standards growth issue in the long run. I do not have a list of prescriptions to offer. I wish I did because, to be honest with you, I feel uncomfortable coming here and saying that there are 10 hypotheses as to why productivity growth has slowed but that I do not think any of them actually seem to be sufficiently plausible that we can just accept them. To some extent, at least, that leaves it unexplained. I am uncomfortable with that, but that is the honest answer I can give you. I do not have a list of proposals to offer. I think everybody would agree that education, skill formation and all of those things are important in the long run. That is the basis of higher standards of living for any modern economy in the modern world. I do not have any particular proposals to offer you and I am obviously not prepared to endorse any particular platform on that score. I am prepared to agree that, as a general principle, those things are all quite important.

Mr TANNER—I just wanted to clarify a couple of earlier answers on the question of an election year erosion of the surplus or a big spending spree or promises by either of the major parties. In response to Dr Emerson's question earlier on, you seemed to be pretty relaxed about that possibility, but, in response to my question, although you did not want to be specific to the public or private sectors, you did re-emphasise the point that is in the written statement that any strong boost to demand, be it from private or public sources, would be a significant worry on the inflation front. I was just wondering if you could clarify for the committee how the bank would view a substantial erosion of projected surpluses in the context of a big spending spree by either major party or spending promises by either major party in a pre-election period.

Mr Stevens—I am not sure that I can give a full statement of 'if this happens, then we think that; if that happens, we'll do this', because one presumes that many of the proposals that will be made will be multiyear proposals. So they will sound like a lot of money over five years, but in

any one year—and in particular in the year or two ahead, which is when we are trying to have our influence—the effects may not be as big. We do not know which of these proposals will actually be implemented. We cannot know that this side of polling day. There are so many uncertainties there that I do not think it is sensible for us to try to spell out particular lines in the sand. All I would say is that I think it is generally accepted on both sides that we need to keep the public finances in good, long-run shape. By and large, we have done that for quite a long time now, stretching back many years. It is a truism to say that clearly that needs to continue, but I think everybody knows that, don't they?

Mr CIOBO—Governor, with respect to the wage price index, I wonder if you are willing to quantify whether or not the RBA has an upper limit in terms of the degree of comfort that you have on that? Further to that, given a significant element of discussions this morning has focused on wages, I am wondering if you would be willing to provide some commentary on the consequent impact on inflation if we saw a tightening of labour market flexibility and whether or not there would also be a problem if we saw the creation of a disincentive to employ additional staff?

Mr Stevens—Is there a line in the sand on wages? I am reluctant to draw too many lines in the sand on most of these things. The real question I suppose is: what pace of average wage growth achieved over time would one expect to be consistent with inflation being at an average of 2½ per cent? We could maybe quantify it like that. That is actually where the productivity assumption you are making comes in. On the assumptions that we have tended to make up until now, a suitably measured wage growth probably in the fours might be consistent with an inflation rate averaging 2½, all other things given and presuming we were measuring the right concept of wages. There are some technical reasons, which my colleague on the left could explain if you really want to hear—and I am not sure that you do—why the wage price index is not precisely the ideal measure to do that calculation with. That is not to say that should a particular measure exceed the number by 0.1 somehow we rush out and crunch the economy. Things, as you know, are not quite that mechanical.

The other question I think was: what would be the impact of removing or substantially lessening the degree of flexibility which, over quite a long time now, has come into the labour market? I do not think it is any secret that if, for some reason, labour markets became much more rigid, much more prone to very large wage increases, which were not related to productivity and which flowed across industries the way they did many years ago, that that probably would constitute something of a problem for managing resource booms like we presently have. I am not sure whether you are suggesting that someone is proposing that outcome but, in that hypothetical case, I think that could be a problem. I am not sure that we will see that hypothetical outcome.

Mr TANNER—I think we have just had a nil-all draw, mate.

Mr McARTHUR—Has the Reserve Bank got any assessment of the price of oil in the medium to short term?

Mr Stevens—What we would typically do for the purposes of making our own forecasts is to make an assumption, and it is fairly transparent I think in the forecast part of the statement what that assumption is. I do not think we could do much better than look at what the professionals

who are pricing the oil futures are doing. I think at the moment they do not anticipate a great change either way. Is that correct, Mal?

Dr Edey—Yes, that is right. Oil is about $60 a barrel, at the moment, which is what we have built into the forecasts. If it stays about that level, it will be roughly neutral for the CPI in the next few quarters.

Ms GRIERSON—I am not proposing that money be free, but why can't Australians enjoy the low interest rates being enjoyed by countries like New Zealand, Switzerland, Canada, Sweden and the United Kingdom at present?

Mr Stevens—Actually New Zealand's cash rates are higher than ours by about a percentage point. Many New Zealanders have fixed rate mortgages, which are actually lower than the cash rate. It is open to Australians to have fixed rate mortgages if they wish. No-one is stopping them. In recent times people have been more likely to take out such loans.

Why don't we have interest rates as low as some of the other countries that you mentioned? The inflation rate is not as low is the main part of the reason. To reduce this to the extreme, why don't we have rates as low as Japan? Because we have not had a 10-year contraction and deflation and a seriously, to say the least, impaired banking system. The interest rates we have reflect the circumstances of the economy that we live in. I think they are the right rates at the moment.

Mr KEENAN—I want to briefly return to the labour market. I am sorry to harp on this, but it is certainly the most serious issue that business brings to me on a pretty regular basis. I note that before you did not want to draw a link between immigration and other policy areas, but what sorts of consequences would you envisage if the government is not able to find a solution to increasing the supply of labour, either through immigration or possibly through participation—although I note that participation is already at an all-time high.

Mr Stevens—Participation is rising, and noticeably rising among 55- to 64-year-olds. Of course, as you know, one of the big issues for the future will be retaining the services of workers in that age group who, some years ago, might have been thinking that they would be retiring by then. But that seems to be moving in the right direction.

Labour is a resource for the economy, and if you have not got enough of it, that does constrain your growth. If we are all working, that is it, there is no more additional supply of labour and presumably that does constrain the economy's growth rate from that point. But the question is: how big a problem is that? Everyone who wants a job can find one, that is what we want the labour market and the economy to do for us. The problem of full employment, as I said before, is a problem you would rather have—if 'problem' is the right word—than the alternative where there are a lot more workers than there are jobs for them to do.

Ms BIRD—Do you have a view on new forms of financial products on the market that are encouraging people to attack their assets and their savings, which Mr Battellino talked about, in terms of drawing down on it in other ways for expenditure?

Mr Stevens—So we are talking about reverse mortgages equity withdrawal and so on?

Ms BIRD—Yes.

Mr Stevens—When you have a competitive and innovative financial system you will get attempts to develop new products. On the whole, in most markets we like innovation and new products and cheaper pricing. To the extent that some of these products would allow people in their old age to more easily manage their balance sheet—

Ms Bird interjecting—

Mr Stevens—There is the old description of people who are asset rich and income poor. To some extent, I do not think there is a lot wrong with the idea that someone who is asset rich and income poor in the later stages of their life ought to be able to access some of the equity. The question is really to do with at what price they do that and whether they are fully cognisant of the risks that they run. That really is the main question in many financial issues.

Most of us generally think that people should be free to make their own decisions. Where we worry is whether they fully understand all the implications of the decisions that they make. That is a matter of disclosure and education and so on. So I suppose we sometimes wonder whether these products will allow people to get into trouble. They probably will in some cases, but does the fact that you could get into trouble with something mean that you should not be allowed to use the product? I would not go that far. It is a disclosure and education question, I guess.

Mr SECKER—This is more of a fundamental question. We have demand-driven inflation, a higher disposable income, and we have cost-driven inflation—for example, high energy prices. Does the Reserve Bank treat them differently and do they put a different emphasis on each part of that inflationary component?

Mr Stevens—In the end, the objective of policy is medium-term performance of the CPI. It is not quite true to say that the rises in energy prices, to take that example, have been a supply event. It was a demand event but in the global economy. It was not so much our demand, although we are part of the strong global demand for energy; it was the expansion of China and other countries in Asia and the rate at which their demand for energy was growing that was outstripping the capacity of supply to keep up. It was not a supply shock in the sense of when OPEC turned off the taps in 1973 and the level of supply went down; the level of supply has been rising in recent years but it has been struggling to keep up with demand at least at the old price. That said, this was an event that was predominantly due to global things.

How do we treat an event like that? The way we treated it was to say that the very short-term effect of that we cannot control. We cannot finetune CPI inflation with monetary policy. Our job is to try to keep it at the right place on average and we take the upshocks and the downshocks on oil as things that in the short run we cannot control. But what we can do is influence the later round impacts of those things and that is what we have basically sought to do. We try and work out—and this is a general point about analysing the economy—what caused the thing to happen that we are looking at; why it happened; how it be will resolved; and how we can contribute to that.

Michael Breckler—To what extent is the interest rate differential between Australia and other countries driving the level of foreign investment in Australia, or would you say it is more a profit motive?

Mr Stevens—I think the fact that interest rates are higher here than elsewhere drives some investment of a kind of short-term nature—for example, we hear a lot in the international public discussion of the so-called carry trades: you borrow and invest in higher yielding assets. This is another reason that the level of rate in Japan is unnatural, not without consequences. There is that and money comes into Australia for that reason. It also comes here more generally though because as a whole this is an attractive place to invest capital. It is not just the short-term interest rate that drives that; the return on business capital stock that we have is attractive. As Ric was saying earlier, a lot of people like to invest in the US because it is fundamentally an attractive destination for capital. So in our own small way is Australia, and that is the other part of the story on capital inflow.

Joshua Lever—Do you think the relative ease of obtaining credit, especially compared to previous generations, contributes to the increased level of household debt and is this level of debt financially dangerous for families in this situation?

Mr Stevens—Yes, it does contribute. There is no question that it is much easier today to get a loan than, say, when my parents went to the bank and, on bended knee, pleaded with the manager—

Ms BIRD—I think I did that in the eighties!

Mr Stevens—'Could we have a loan?' and the manager said, 'Well, do you have a saving record with us?' and so on and so forth. Now they are probably calling you on the phone while you are trying to eat dinner, offering you a mortgage without having seen you in some cases. So it is much easier to get credit.

Is it dangerous? For some people it probably is. I am surprised no-one has asked about the stories in the papers about mortgage repossessions and so on in some parts of the country. As tragic as that is, it is largely a result of the fact that lenders—and this is not mainly banks; it is non-bank lenders—are today prepared to lend money to people who would not have got loans long ago. Some of those are quite risky, and unfortunately some of these people get into trouble. So there is no doubt that there is a connection between the two; I think that is quite clear.

CHAIR—Sharon Grierson wanted to ask one question regarding the payment review.

Ms GRIERSON—Are you confident that you will have full access to the most relevant and reliable data to inform the review regarding credit card reforms?

Mr Stevens—I think we will, because almost as we speak we are embarking on the cost study. I think Dr Lowe can speak in more detail on this, but our staff are already talking to the relevant institutions to collect the data and we will also be commissioning some survey work on how the households actually use the various payment mechanisms. So I think we will have the most up-to-date data that it is possible to have. I do not think there is a problem there.

Dr Lowe—We have already had some discussions with the financial institutions and merchants and they are being very cooperative. As Glenn said, we do not expect any problems.

CHAIR—I would like to thank the governor and the senior members of his executive for coming to Perth, the current boom state. We appreciate you taking the time. On behalf of my colleagues, who have also come today, can I say we appreciate it. We thank Michael Keenan for encouraging us to come. I declare this public hearing closed.

Resolved (on motion by **Dr Emerson**):

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 11.12 am