Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration

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Governor

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Mr Chairman, members of the Committee.

My colleagues and I welcome the opportunity to appear before you today. I have attended most of these started in their current form in May 1997, and have observed over that decade the way they have becor part of the monetary policy framework in Australia. I am sure that their importance will continue to grow and I look forward to taking part in them.

It is fitting that this hearing take place in Western Australia, where the effects of some of the profound ir affecting the economy are perhaps clearest. I refer of course to the rise in the relative price of natural re increased shareholders' and employees' incomes in the resource sector, increased the flow of labour ar sector, and had a flow-on effect on a range of other industries. This has all fostered a generally very ex 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 inc one is no exception. In the south-eastern part of the country, where direct exposure to the resources se positive impact is not as strong. In addition, the other dimension of the change in relative prices to whicl decline in prices for many manufactured products as a result of the emergence of China and other low- affecting local producers. Not surprisingly, those parts of the economy, while growing, are experiencing seen here in the west.

Nonetheless, the rise in Australia's terms of trade of over 30 per cent over the past three years, taking t level for 50 years, is expansionary overall. The real incomes of Australians are higher and, other things demand. For macroeconomic policy, it is a matter of ensuring that the economy adjusts to the change a possible.

That task is easier today than it once was. A more flexible economic structure, a floating exchange rate macroeconomic policy framework mean that the adjustment is proceeding much more smoothly than it occasions in history when the terms of trade moved by large amounts. As a result, such adjustments to have been required have been gradual.

When we appeared before you in August last year, the economy was in the midst of a mild pick-up in in something that we had anticipated would occur, and to which monetary policy had already begun to res adjustments to interest rates in May and August. As you know, there was a further adjustment in Noven 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, is fairly well known. Af solid economic growth, we have approached what for practical purposes can be called full capacity, at l The evidence for this is quite widespread. In the labour market, we are as fully employed as we have be past 30 years or more. The share of the working age population employed is at a record high, the rate c its lowest for a generation, and wider measures of 'underemployment' are also comparatively low. It ma these trends to go further yet, but a wide array of business enterprises the Bank talks to have been sayi it is harder and more costly to find appropriate staff, and that the factor most constraining further expans demand, but insufficient capacity, either of labour or capital or both.

Approaching full employment is, of course, something to be welcomed. It is a goal of macroeconomic po employment is a 'problem', it is the one you would rather have than the problem of chronic unemployme have full employment, it is appropriate – inflation considerations permitting – for growth in demand to be order to use the unemployed reserves of labour and capital. In the recovery from a business cycle dowr what macroeconomic policies seek to achieve.

But by the same token, once full employment is more or less achieved, the pace of expansion in aggreg earlier desirable will now be too fast. It has to slow a bit, to be more in line with the rate of growth of the capacity. Otherwise, we would face the problems of overheating, inflation and eventually another downt adjustment to more moderate outcomes for spending and output growth which we have been seeking ir

years.

That this is necessary is confirmed by the fact that inflation has picked up somewhat. CPI inflation in 20
In 2004 it was 2.6 per cent, and in 2005 2.8 per cent. In mid 2006 it was nearly 4 per cent.

To be sure, the Consumer Price Index was affected by the rise in oil prices, and most spectacularly, the
Larry on the Queensland banana crop during March of last year. But the rise in prices was more widesp
items. Measures of underlying inflation, less influenced by specific price shocks, suggested a pick-up, a
modest one, from about 2½ per cent to about 3 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 w
capacity, continuing signs of quite solid growth in demand, and experiencing a substantial external stim
trend rise in underlying inflation was worrisome. A continuation of this trend could have seen inflation ex
cent target over a more sustained period, even after temporary factors had disappeared. It was this risk
or petrol prices *per se* – to which monetary policy had to respond. It was intended that the rise in interes
the growth of demand, would allow the supply side of the economy some time to catch up, and so act to
pressures over time.

How, then, do we evaluate the current situation and outlook?

Most indicators suggest the economy expanded at a moderate pace through the second half of 2006. W
construction remained a bit below average, engineering and non-residential building have been very str
demand picked up a little pace, and at present it is being assisted further by the decline in petrol prices.
very serious drought has strengthened its grip on the rural sector, and farm production and incomes will
financial year as a result. The demand for labour has remained very strong, with higher than average in
employment and some further decline in the rate of unemployment through the turn of the year. Data or
from business surveys suggest little moderation in this area in the near term.

Looking abroad, the world economy continues to post a strong performance, led by the US and China. I
have for some time pointed to the possibility of a sharper-than-expected slowdown in the US economy,
weakening housing sector pulling down activity elsewhere, as a key downside risk. To date that risk doe
materialised, and recent data suggest growth has been close to trend for the US economy, even with a
At the same time, recent inflation outcomes in the US show some moderation. There is little sign that Cl
will end any time soon and recent growth in the euro area has recently been the strongest this decade.
made by the IMF and other institutions for the world economy have for some years been qualified by sta
downside risks, it appears that current trends are, once again, at least as strong as the forecasts.

While prices for some commodities have retreated from their peaks, others have remained very high. Tl
prices will, in all likelihood, continue to prompt high levels of investment in the resource sector both in A
No doubt the resulting expansion in supply will, in due course, dampen prices for commodities to some
appears likely that Australia's terms of trade will be higher on average over the years ahead than they w
1980s and 1990s.

International financial markets remain remarkably supportive of growth. Long-term interest rates are not
50-year lows of a few years ago, even though short-term rates have risen in most countries to be much
levels, the main exception being Japan. Share prices have been rising steadily, appetite for risk is stron
prices for financial instruments has been remarkably subdued.

To some extent, these trends in financial pricing may well reflect a genuine decline in some dimensions
Variability in economic activity, and in inflation and interest rates, has clearly diminished over the past 1
countries, including Australia. The associated prolonged period of attractive, steady returns on equity in
of long-term debt funding certainly seems to have set the stage for a return to somewhat higher leverag
sector. This is most prominent in the rise in merger and acquisition activity and the re-emergence of lev
around the world. Corporate leverage had been unusually low after the excesses of the 1980s, so some
manageable. Nonetheless, after more than a decade in which the main action in many countries has be
balance sheets, this trend in corporate leverage will bear watching. For the time being, at any rate, finar
providing ample support for both corporate investment and household spending around the world.

Turning to the outlook for domestic demand, the very high rates of growth of business investment are n
us, but the current high *levels* of investment are adding to the capital stock in a way that should, in time,
constraints. Governments in several states, conscious of the need for public infrastructure, are also look
investment. There appears to be considerable competition for the resources needed to complete all the

A gradual expansion in residential construction activity will probably get under way over the next year. V
consumption will grow at about trend in the period ahead. In both these areas, our expectations take int
the impact of the monetary policy adjustments made last year are still working their way through the hou

All of this should mean that domestic demand will rise at, or slightly below, trend pace over the coming y
export sectors expanding as additional capacity comes on line, our central forecast is for growth in non-
to about trend during the next couple of years. Total GDP growth will be lower in the near term because

effect on the farm sector. If rainfall patterns improve in the months ahead, there would presumably be s
production during 2007/08, though the likelihood of that, let alone its strength, is inevitably highly uncert

So far as the outlook for inflation is concerned, at the time of our November 2006 *Statement on Moneta*
three policy adjustments made last year, we believed there were grounds to think that the higher inflatio
up to that time would moderate a little in the period ahead. We were, admittedly, a little tentative in that
on that assessment, the Board elected to leave interest rates unchanged in December.

At our most recent meeting two weeks ago, we felt we could be a little more confident in that inflation fo
course, see some large movements in CPI inflation in the next few quarters. It will probably fall noticeat
an annual basis, as falling petrol and banana prices have their effect. After that, it will rise again, as thos
fade, and we currently expect that CPI inflation will be around 2¾ per cent by early 2008, remaining aro
thereafter. That is, it appears likely to be lower than recent outcomes, but closer to the top than the bott
target range.

With that outlook, the Board decided in February to maintain the existing setting of cash rates. We will b
watch on what incoming information tells us about the prospects for inflation. The apparent softening in
the December quarter was certainly very welcome, but it is not as yet clear to what extent it signals a pe
to a temporary, phenomenon. Most of the indicators we have available still suggest a very fully employe
would be some risk of inflation remaining uncomfortably high were demand growth to be unexpectedly s
term. Hence the outlook for demand, and the extent to which capacity constraints are easing in a range
key elements in forming a judgment about the outlook for inflation, and the appropriate stance of monet

I turn now to payments policy, which I know is of interest to this Committee. You conducted a very exter
last year into payments issues and we believe that was very useful as a way of airing the views of the v

In 2002, when the Payments System Board announced the credit card reforms, it committed to reviewir
five years. We will meet that commitment with a review that will take up this year and part of next. The r
scope and will include all the Bank's reforms to date.

I know that some industry participants have expressed reservations, including to this Committee, about
another body, conducting the review. I note that the Committee was not convinced by their arguments a
Bank should conduct the review. From our point of view, having publicly committed to carry out such a r
could hardly do otherwise. Moreover, it would be very odd indeed for the Payments System Board, whic
by the Parliament with making payments policy, to ask some other body to review its policy decisions. It
the Parliament, including via this Committee, to review the reforms in any way that it sees fit and to ask
Board to account for its decisions.

In December last year, the Payments System Board announced the outline of the review, after inviting i
participants. The formal part of the review will begin mid year, when the Bank releases an issues paper,
form the basis for an initial round of consultations. As background to the review, we will also be underta
research into costs and usage patterns of the various payments methods, including cash. This will upda
study on costs carried out seven years ago.

The review will be an open process, which will include a conference towards the end of this year bringir
policy-makers, specialist academics and industry practitioners. We plan to release our preliminary conc
of 2008 and then we would again consult widely before making any changes to the current arrangemen
review to be completed in late 2008. This is a lengthy process, but it has to be if the discussion is to be
everyone with something to say heard, their views considered carefully and the PSB to undertake prope

It is important to add that while the Payments System Board's reforms to retail payments systems have
of attention, the Board is concerned with a much broader set of issues, including the stability of the payı
Board's main focus here is the operation of the high-value payments systems. These systems continue
degree of reliability and security, but continued attention and investment on the part of the principal play
RBA, is needed to ensure that this remains the case over the years ahead.

Mr Chairman, that concludes my introductory remarks. My colleagues and I are here to respond to your

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