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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

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SYDNEY

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 18 August 2006

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

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

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2005

WITNESSES

Committee met at 9.57 am

BATTELLINO, Mr Richard, Assistant Governor, Financial Markets, Reserve Bank of Australia

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

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

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia

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

CHAIR (Mr Baird)—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration, and welcome representatives of the Reserve Bank, students and staff from secondary schools in the Sydney area, members of the public and the media. The hearing today provides an opportunity to examine further the underlying reasons behind the recent rate rises. In particular, the committee is keen to examine the impact on the level of core inflation of rising petrol prices, limited spare capacity, global inflationary pressure and the tight labour market. The committee is particularly interested in what the RBA's analysis is showing with regard to the impact of high petrol prices and rising interest rates on consumer confidence.

The committee notes the widening gap in economic performance between the best performing states of Western Australia and Queensland and the less performing state of New South Wales. While we have raised this point at previous hearings, we are keen to discuss further the extent to which this wide growth gap should form part of the RBA's deliberations.

On the global economy, the committee notes that the US Federal Reserve has stopped raising interest rates after 17 straight rises. The committee will seek to examine the impact on the Australian economy of growth forecasts in the US economy and also in Asia and China in particular.

Once again, on behalf of the committee I welcome the governor and other senior officials of the Reserve Bank of Australia to this hearing. I note that this may well be the last appearance of Mr Macfarlane before this committee, and I take this opportunity on behalf of the committee to commend him on his performance as RBA governor, and I will be saying a couple of words at the end of this session. I also take the opportunity to congratulate Mr Stevens on his impending appointment, and particularly so as he comes from my electorate.

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 a contempt of parliament.

Before I ask the Governor of the Reserve Bank to make an opening statement, I acknowledge the presence of students from a number of schools from within and around Sydney. Mr Macfarlane, would you like to make an opening statement before we proceed to questions?

Mr Macfarlane—Thank you. The present arrangement whereby the Reserve Bank appears before this committee every six months was put in place by the current Treasurer 10 years ago. During that period I have appeared 18 times, two meetings being missed because of clashes with elections. This will be my last appearance. I think I will miss this regular half-yearly event; perhaps I should come back and sit in the bleachers for future meetings.

CHAIR—You are always welcome.

Mr Macfarlane—Thank you. I have always thought it was a very good principle for the central bank to have to report regularly to parliament and to be subject to questioning by members. The practice has, I believe, been a valuable form of communication and has contributed to improving monetary policy in Australia. Since this is my last appearance, I seek the Chair’s indulgence to start by covering some medium-term considerations before proceeding to the current economic situation.

As you are aware, Australia’s current economic expansion is now in its 15th year, and there is a general recognition that this is a good thing and, as a result, there has been an increase in the degree of optimism about Australia’s economic performance. This is in marked contrast to the general pessimism that prevailed in the 1970s, 1980s and even later when people were worried that we were falling down the international ladder and falling behind other countries. After such a long expansion, however, it should not be surprising to discover that the economy has been experiencing some capacity constraints. A lot of people are disappointed to hear this and regard it as a bad thing, so I would like to spend a bit of time discussing this issue which, incidentally, we first began raising 18 months ago at the February 2005 meeting of this committee.

First, what is termed full capacity is not a bad thing; it is a good thing. It means, for example, that we have low unemployment and that our incomes are higher than they might otherwise be. What would be a bad thing is if, after 15 years of growth, we still found ourselves with significant excess capacity, that is, significant resources of labour and capital that were not being utilised. Economies are meant to operate somewhere around the zone of full capacity; not permanently below it.

Second, there is no sensible alternative monetary policy that would have prevented us from entering the zone of full capacity. The only way monetary policy could have prevented this is if it had kept the economy semicomatose. That would have meant growing so slowly on average that even with the passage of 15 years it did not use up its excess capacity.

Third, full capacity is not a brick wall that you suddenly hit—approaching it is something that happens in stages. It is a rather patchy process with some sectors reaching it early and some not at all. That is why I call it the ‘zone of a full capacity’. Sometimes it is an industry that becomes a bottleneck, sometimes a type of capital equipment and often it is a type of skilled labour. The situation that attracts the most attention is when it is a piece of infrastructure, such as a port or a railway. Normally, when the Reserve Bank talks about capacity, we are not talking about the specific pieces of infrastructure but about the economy’s overall availability of labour and capital resources. It is also worth keeping in mind that it is normal for the capacity of an economy to grow over time. This is because the labour force grows and investment and economic reforms lift output per worker or productivity.

There are limits, however, to how quickly capacity can be raised, though increased investment, as is taking place at present, will boost the rate of increase. But it takes time. In the meantime, it is helpful if demand can slow sufficiently to allow capacity to catch up or perhaps even get a little ahead. If this fails to happen then there is a risk of a generalised pick-up in inflation. Some rise in prices and wages in the areas where the bottlenecks exist are unavoidable but a generalised inflationary process is avoidable. This is why last year I started staying that we should get used to GDP growth with a ‘2’ or ‘3’ in front of the decimal point rather than the ‘3’ or ‘4’, as we had been accustomed to throughout most of the expansion.

In light of what I have just outlined, I would like to review our progress to date. The first thing to note is that, over the past two years, the economy has slowed from its earlier fast pace of growth. The last time we had a GDP growth of over four per cent was in the year to June 2004. Since then, the growth rates have had a ‘2’ or a ‘3’ in front of the decimal point. There are a number of indications that growth has picked up again over the past six months but our forecast did not have it going back anywhere near the four-plus rates of a few years ago.

Also, domestic demand has slowed more than GDP. If you remember, it was running at about six per cent for a few years, particularly the few years before 2003-04, but it is now growing at about 3½ per cent. More importantly, the composition of domestic demand has changed for the better. The driving force behind the demand growth for a long time was consumption spending, but that has now clearly slowed. Two years ago, consumption was growing at more than six per cent per annum, but over the past three quarters it has been growing at slightly less than three per cent. There is some evidence to suggest that the slowing in consumption was due in part to the fact that household spending was no longer being stimulated by the apparent wealth increases associated with the house price boom. The gradual tightening of monetary policy, which began in 2002, no doubt also played a role.

At the same time as consumption and overall demand have been slowing, investment has grown strongly. This is important because investment in plant and equipment and in construction is crucial to the process of increasing the economy’s capacity to grow. Over the past three years the capex survey, done by the Statistician, shows that investment has grown by nearly 16 per cent per annum. Much of this has been in the resource sector, as we know, but even if we take this out of the figures the remainder has grown at 12 per cent per annum. Even in manufacturing, which many people assume has floundered, investment has grown at a similar rate—although a lot of it has been held up by resource related activities. In the long run, this strong investment performance increases the economy’s supply potential and hence puts downward pressure on inflation. In the short run, however, it is pushing up the prices of many inputs and wages in the construction and resources sector.

The capacity constraints caused by shortages of labour are harder to remedy in the short term. Interstate movement of labour can help to provide skilled and unskilled labour to the areas that have the greatest shortages, mainly in the resource sector and its supplying industries. At the same time, increased immigration has helped to expand the overall supply of skilled labour. But, clearly, more has to be done to attract people into the occupations where skills shortages are most acute and to train them without unnecessary delay. I do not profess to be an expert in this important area and I do not want to lecture the federal and state governments on this issue, which I know is already absorbing a lot of their attention.

The process of slowing demand and expanding capacity has been going on for several years but it has not prevented some general upward pressure on producer and consumer prices. This was brought home to the public with the publication of the June quarter CPI. The increase of four per cent over the year to the June quarter made headlines, even though many observers were quick to point out that more than half of the June quarter increase was due to petrol and bananas, the latter influence giving the cartoonists of Australia many opportunities for mirth. They were correct to downplay these two influences, which in all probability will probably either reverse or revert to zero in the coming quarters. But there is also a danger of simply taking out the two fastest growing components and looking at the rest of the CPI basket.

At the bank we tackle the problem of lumpy and possibly one-off price movements by looking at various measures of underlying inflation. Our preferred measures show that underlying inflation is running slightly below three per cent per annum; this has picked up moderately since the start of the year, after a period when it had been fairly stable at around 2½ per cent. The bank’s mandate is to keep inflation averaging two to three per cent over the medium term. This does not mean that it is never to exceed three per cent or to fall below two per cent; it clearly had done both during the inflation-targeting period. We need to be confident however, that it will return to the two to three per cent range. Viewing all the available evidence that has accrued over the six months since we last appeared before this committee, the board came to the view that inflation was likely to exceed earlier forecasts and that corrective action was therefore needed.

As you know, the cash rate was raised by 25 basis points in May and again by the same amount earlier this month. In making these decisions the board was conscious that the global economy remains very strong, with output expanding at above-average pace for the fourth year in a row. It also noted that global inflationary pressures have been rising. This is in part the consequence of the very accommodative monetary policies that the major countries ran over the 2003 and 2004 period. While the English-speaking countries have generally returned interest rates to more normal levels, the continuing low level of interest rates in Asia and Europe means that global interest rates, on average, remain low. This is continuing to stimulate global economic growth and inflation.

Domestically, there has been a pick-up in the pace of economic growth after a mild slowing in the second half of last year. While the pick-up has not been excessive, the general message from the growth of employment and consumer spending was that the household sector is still in good shape and has not retreated into its shell as a result of the rises in petrol prices and the May interest rate increase. The fact that borrowing by the household and business sectors has accelerated over the past six months or so confirms this general picture. But, as indicated earlier, the most important consideration behind our thinking was that our forecast of underlying inflation has had to be progressively revised upwards over the past six months.

Before closing and moving on to questions, I would like to thank the committee again for the work that it has put in during the years that I have been appearing before it. Not only has it kept an eye on monetary policy developments; it has also done a valuable job looking at payment system developments. The recent two-day hearing on payment system reform shows how willing the committee has been to devote time to important issues and how effective such public inquiries can be. I will of course be willing to answer any questions on the economy, monetary policy, financial stability or payment system matters that you may wish to ask. Alternatively, you may wish to look to the future and address them to the next Governor of the Reserve Bank, Glenn Stevens. I am sure he will be as forthcoming with you as I hope I have been. Thank you very much.

CHAIR—Thanks very much, Mr Macfarlane. Is it the wish of the committee that the statement made by the Governor of the Reserve Bank be received as evidence and authorised for publication? There being no objection, it is so ordered. It was a very interesting review, as usual. I notice that in the second paragraph of your introductory comments you say, ‘As you are aware, Australia’s current economic expansion is now in its 15th year, and there is a general recognition that this is a good thing.’ But I think in the last week you have indicated that it would be a miracle if Australia did not experience a recession some time in the next seven years. What factors would you see leading to that, and is there concern about it to the global economic scene—the role of China—or the question of an overheated domestic demand?

Mr Macfarlane—I think I was just really making a sort of statement based on nothing much more than statistical probability. I think in the same interview I said that when I took up this job 10 years ago we were already five years into an economic expansion and I had a seven-year term and I thought, ‘Will we get to 12 years?’ Not very likely, I thought. In my working life, expansions had all lasted only seven or eight years, so I thought it was highly unlikely we would even get through my first term. As it is, I have added another three years onto that and this expansion has been going for 15 years. I think it is important for people making business decisions to recognise that this is not a normal state of affairs, that it would be unwise to plan business decisions, including borrowing decisions, on the assumption that the next 15 years are going to be just as smooth as the last 15 years. This was really the point I was trying to make. I am not trying to make any bigger point than that. I feel utterly confident that monetary policy will be conducted just as well going forward as it has in the past. As I say, I am really making a statement about statistical probability.

You were saying, ‘What could come along to make things more difficult?’ I was not talking specifically about recession. I was just saying that this period of great stability was not the normal state of affairs and therefore you could not assume that it would last forever. I would make one observation, however, and that is that, in my working life, the only time Australia has had a recession has been as part of an international recession. So we had one in 1974, as the rest of the world did; we had one in 1982, as the rest of the world did; and we had one in about 1990-91, as the rest of the world did. We skipped one. It was a mild one. There was an international recession in 2001, and we skipped that. A couple of other countries did too. The UK skipped it, for example. So my feeling is that history has said that we are really only vulnerable to having a recession at a time there is a world recession. At the moment, that seems highly unlikely. At the moment, with the world economy really only in the fourth or fifth year of an expansion, one would assume that that world expansion would continue for quite a while.

CHAIR—Are oil prices part of that?

Mr Macfarlane—That is very interesting, because if you go back and look at the two previous big rises in oil prices, which are called OPEC 1 and OPEC 2, they both were followed by recessions. But it is not clear that they were the cause of the recessions, because in both cases there was a whole lot of other inflation as well as rises in oil prices. On this occasion, of course, that has not happened. In fact, on this occasion the world economy has proved remarkably unaffected by the rise in oil prices. If you had told most of us three years ago that oil prices would treble, we probably would have expected a much worse economic outcome than the one that has occurred. Basically, economic growth around the world has not slowed at all. It has had no impact in terms of slowing economic growth, and inflation has gone up only by a small amount. It has been much, much better than anyone, even the greatest optimist, could have predicted. Part of the explanation for that is that the rise in oil prices was due to strong world growth; it was not due to a cartel withholding supply, as it was on the previous two occasions.

CHAIR—I noticed in the economic statement that was put out a week ago that there were projections of the core inflation rate being likely to be three per cent over the next two years. Does that increase the probability of further rate increases?

Mr Macfarlane—I was wondering when this question would come up and how it would be phrased. I think at the moment that the assessment that is in the market is probably about the right assessment—that it is more likely that there will be than that there won't be. It is not as though we have an agenda which we are not telling anyone about and we are planning to do something. We are not. But I think, with the sorts of capacity constraints we are talking about and with the economy growing at a reasonable rate and probably inflationary pressures coming from abroad, it is more likely that there will be than that there won't.

CHAIR—My final question is one about the two economies and whether we are seeing two economies currently operating, given some of the growth factors of Western Australia and Queensland versus New South Wales and Victoria. Unemployment in Western Australia is 3.1 per cent and in New South Wales is 5.1 per cent. House prices in Western Australia have increased over the last year by 22.5 per cent whereas they have fallen in Sydney by 3.9 per cent. You have indicated in the past that you make it on an across-the-board basis, but does it start to reach a point where it does have an impact on future projections. There is also the question that, at a time of a fairly slow economy in New South Wales, the people who are hit hardest by the rate increases are in fact the high mortgage holders, based predominantly in Sydney and Melbourne.

Mr Macfarlane—We have covered this at the last two or three meetings because, with the big lift in the terms of trade and the buoyancy of the resource sector, we are all conscious of the fact that Western Australia and Queensland—particularly Western Australia, but also Queensland to a lesser extent—have been growing a fair bit faster than the average for Australia. Just as some states have to grow faster than the average, some have to grow slower than the average. And the big eastern states, such as New South Wales in particular and Victoria, are growing less rapidly than the average.

The first point I want to make is: there is always a dispersion amongst states. We have done calculations of the dispersion over the last 30 years and it is no bigger now than it has been on a number of occasions in the past.

The second point is: there are a lot of things happening; there is a lot of flexibility in this economy which is making things a lot better than they would have been 30 years ago. For example, people tend to highlight New South Wales, but the New South Wales unemployment rate of 5.1 per cent is only slightly higher than the national unemployment rate of 4.8 per cent. That suggests that there is not a big problem of people sitting around in New South Wales not having jobs.

One of the reasons for this is, I think, that there is probably a fair bit of interstate migration going on. The figures on this are very hard to come by because we do not have immigration officials at each state border. So if you pack up and move to another state there is no immediate record of what you have done. It is a difficult one for the Statistician to trace, and you have to rely on things like Medicare, changes of addresses. So we do not have really terrific figures on that, but we think there has been quite a bit of interstate migration going on.

Even with the immigration from abroad, I noticed that, in the last year, for the first time I am aware of, Western Australia had a bigger percentage increase in its employment from immigrants than any other state. You are probably aware that normally New South Wales is the one that gets the big increase in immigration and people then fan out to other parts of Australia. But I notice that now people are coming directly into Western Australia at a much greater rate than they have in the past.

So I think the system is working pretty well. And I think the big test is the unemployment rate. That is the really big test of dispersion. Growth rates are probably not as good a measure. One of the reasons that the New South Wales growth rate has been lower than the average for the country for some time is that the population growth rate has been lower in New South Wales. And there is the same process—people leaving to go to the faster growing areas and, as I have said in the past, I also believe, going to live in the more affordable parts of Australia.

Dr EMERSON—Thank you, Governor. You have just said in response to a question from the chairman that it is more likely that there will be, rather than not be, a further interest rate rise. I want to go through the balance of risks in the statement of monetary policy and also in the statement that you have delivered today.

In the statement on monetary policy of 4 August, the Reserve Bank forecasts that the underlying inflation rate will be at three per cent for each of the next two years, which is a long time for the underlying inflation rate to be at the top of the range. Yet, at page 51, the statement on monetary policy says that the risks are evenly balanced. You point to the international arena as being a source of possible downside risk—that is, that the world economy might not grow as fast as the Reserve Bank is anticipating—but as a source of upside risk you point to such factors here in Australia as inflationary expectations, strong employment growth leading to strong consumer demand, stronger than expected wages growth, stronger than expected credit growth and the influence of oil prices. So there are a lot of domestic factors that could lead to the underlying inflation rate going above three per cent.

My question before the statement today would have been: do you really believe there might be a prospect of a slowing of the world economy? But, when I read the statement, it says that the global economy remains very strong and that this is continuing to stimulate global economic growth and inflation. It seems to me that that removes the downside risk but that all the upside risks remain. So my question really is: what is the balance of risks in the light of the statement today? Is it the case that those risks are very much headed in the upside direction, with all the implications that has for inflation and monetary policy?

Mr Macfarlane—I suppose all I can say is this. On the international economy, I myself am reasonably optimistic that it will continue to grow at the fair pace, but I think it is quite possible that commodity prices may come down because they have risen to such great heights. It is quite possible that you might get some help from falling commodity prices—that is, if you are looking specifically at inflation in the international economy. Domestically, we have had three tightenings of monetary policy over the last 18 months and they have not worked their way through. That may give some relief on the domestic side.

But I think the general thing that people are conscious of is this. If you start from three and you get a random shock—you do not know whether it is in an upwards or downwards direction—the upward ones will push you to a position where you may want to respond, whereas on a downward one you would certainly not reduce interest rates. You would not do that because your underlying inflation went from 3 to 2¾. I think that is the way people are reading the situation, and that is why the market is saying it is more likely that there will be further increases than that there will not be. I cannot improve on what the market already thinks. I think they have made a reasonable assessment of the probabilities.

Dr EMERSON—I will continue on that. There seem to be about five domestic things that could go wrong—that is, that would push the underlying inflation rate above three per cent—and that the only consideration balancing the risk in the other direction would be a slowing world economy. But today you are really saying that the global economy remains very strong and it is continuing to stimulate global economic growth and inflation. If we have up to five factors in the domestic economy that could trip the underlying inflation rate above three per cent and now a statement saying, ‘Well, it seems unlikely that there will be a downside or offsetting factor from the global economy,’ then you have six factors that could force the underlying inflation rate above three per cent and no factors that could ameliorate that probability.

Mr Macfarlane—I think I gave you two factors that could. I think I said that world commodity prices, which have risen a lot, could fall and, similarly, that monetary policy could slow the economy more. I think there are some factors which give you a chance of it being lower. But the thing is that, if it is lower, it is only coming off three. I think that is the crucial thing that we obviously concede, and that is what the market looks at. Do you want to add any more to that, Malcolm?

Dr Edey—The main thing I would say is this. Usually what we are trying to do when we technically create the inflation forecast is pitch it at a point where the risks are evenly balanced, because that is just the nature of the forecasting process. It is always possible that any of the factors that affect inflation could turn out to be stronger or weaker than what we thought, and we include some illustrative discussion about how things might turn out differently to how we think. Usually the forecast is pitched at the point where the risk around the forecast itself is evenly balanced. Sometimes we do actually go out of our way and say, ‘No, we think the risks are tilted a bit in one direction or the other,’ and usually that is driven by the fact that there is some information there that is pushing you a bit further in one direction but is not strong enough to discreetly change the forecast.

Dr EMERSON—Since the decision to increase interest rates in August and the issuing of the statement of monetary policy on 4 August, there has been more information in the public arena: the release of very strong employment figures. On the other hand, there was the release of figures on consumer confidence that showed a sharp decline. I have a graph here mapping consumer confidence. Consumers sometimes behave like the song, 'I get knocked down, but I get up again. You're never gonna keep me down.' An interest rate increase knocked down consumer confidence—

CHAIR—Sing it.

Dr EMERSON—Later, during the wind-up session when we start singing tributes to the governor! That is what has happened with consumer confidence: an interest rate rise will come along, impact, consumer confidence will plummet and then, within a month or two, if you look at this graph, it rebounds. Why am I say that? It seems to me that, if that pattern is repeated, if consumer confidence recovers, we do know that there are very strong employment growth figures and so, in terms of that balancing of risks that leads to a forecast of an underlying inflation rate of three per cent, the balance is tipped the other way towards a higher probability.

We know the market is factoring in about a 90 per cent probability of one more interest rate rise. I know you are in an invidious position to talk beyond that, but I am suggesting that there are fundamentals going on in the domestic economy and the global economy that could well result in further interest rate rises—that is, that we have not finished in the tightening cycle.

Mr Macfarlane—Can I say something about that consumer sentiment graph which you are referring to? Unfortunately I have not got it in front of me but I can picture it, because I have been looking at it recently, and it is true that the falls of recent periods—no, give it to the chair. I do not want to look at it; I know what it shows. The big falls are partly recovered and then another big fall occurs. But if you look at that graph, you can see that consumer sentiment, at the moment, is at quite a low level. It has fallen significantly over the last two years, just as, as I said in my opening statement, consumer spending was running at six per cent and is now running at less than three, which is consistent with those falls. I would not be anywhere near as confident that it is just going to bounce back again.

I think what has happened with monetary policy, with the fact that house prices have not continued to rise and with the fact that people have been very sensitive to the increase in the price of petrol, whilst consumers have not gone into their shells, they have certainly slowed their spending down and they may slow it by more. But we do not know; we will have to see how things pan out. I would not use that graph on consumer sentiment to support the view that consumers are just going to bounce back, because I do not think they have. I think over that period, if you look at it over the last to years, the level of that thing has definitely come down quite a lot.

Dr EMERSON—Only from about 18 months ago. But my next question again relates to the statement today on skills shortages. You have said that you first began talking about capacity constraints in February 2005. Others have been talking about them since 1999, including the member for Batman. You say it is hard to remedy in a short time, but what is your view on the role of skills shortages in creating the reality that domestic demand is not being met by domestic supply and that is causing inflationary pressures? Have skills shortages been a significant factor in creating that inflationary pressure?

Mr Macfarlane—Firstly, I reiterate that I am not an expert as to how you remedy this problem but I think at the aggregate level you would have to say that it has not had anywhere near as big an impact as we would have thought. The growth of earnings—the wage price index—has crept up very slowly. Private earnings are at four per cent—4.1 per cent, I think—and, with the productivity performance we have in Australia, four per cent is not inconsistent with maintaining inflation at 2½ per cent. Even though in particular localities and with particular skills there have obviously been big increases, there is enough flexibility in the Australian labour force at the moment so that it has not impacted on aggregate wages in a way which has threatened our inflation forecast.

Dr EMERSON—The figures that came out yesterday seem to suggest that, at the lower end—that is, the less skilled end—penalty rates are being wound back significantly and that is affecting the overall wage aggregate figures, the growth figures. However, in the statement of monetary policy, you refer to bonuses. I have had a talk to some of the financial institutions. The bonuses are not restricted to the Western Australian mining industry. The financial sector needs to offer bonuses to attract people and to offer 'handcuff' bonuses to retain them: 'We will give you an extra $50,000 if you stay for three years.' Is it a reasonable interpretation that the highly skilled end are getting bonuses, which is contributing to wages growth at that end, but the less skilled end is losing penalty rates, with the overall result of a growth of four per cent, meaning that wages growth has not at this stage exceeded around four per cent per annum?

Mr Macfarlane—I do not wish to dispute your interpretation other than to say that our responsibility is for inflation. It is the aggregate that feeds into inflation and, at the moment, the aggregate is not running at a rate which, of itself, is inconsistent with our maintaining the inflation objective.

Dr EMERSON—But is the interpretation a reasonable one?

Mr Macfarlane—You have put more time into interpreting yesterday's figures than I have, so I certainly do not want to dispute your interpretation.

Mr SOMLYAY—At the last meeting you talked about the external influences on inflation—that China was a major restraint against inflationary pressures in Australia. Do you see that restraint continuing given the increasing price of commodities that China needs to produce its exports?

Mr Macfarlane—The growth of China is undoubtedly having a very big impact on the world inflation rate, and it does so in two separate ways. Firstly, it does it in a very helpful way because it is flooding the world with manufactured goods, the prices of which are mainly falling. We, of course, are a beneficiary of that because we are a big importer of a lot of those manufactured goods. On the other hand, it is pushing up the rate of inflation because it is demanding so much more in materials. We know what has happened to iron ore prices, coal prices, copper prices, nickel prices—you name it. So China's net effect on world inflation is not clear. It is probably slightly positive, because world inflation is edging up. We are in the very fortunate position of benefiting from the cheaper manufactured prices and also our big resource companies are benefiting from the rise in the price of raw materials. That is very helpful to our incomes—it makes the country richer—but at the margin it pushes up inflation in those areas, which is what we have just been talking about.

Mr SOMLYAY—This week the Treasurer put out a statement where he quoted you as saying:

I have been lucky—for most of my time, fiscal policy has consisted of small surpluses.

So the movement in the government account has not been big enough to be important in the consideration of monetary policy.

It might become an issue because the states are now part of the equation.

In 2002 when I asked you the same question in Warrnambool, I think, on one of our regional visits, you were not concerned about state deficits at that time. What has changed between 2002 and now?

Mr Macfarlane—I thought we were going to get on to fiscal policy; we always have a big session on fiscal policy. I will start by going back to our last meeting here, where there was a lot of discussion on fiscal policy. The Treasurer at that stage was under intense pressure from the media, his own party and the opposition to make really big tax cuts which would have resulted in a very big fiscal stimulus. I did not think that was a very good idea. I thought that a big fiscal stimulus would not be very helpful, so I did my best when I answered the questions to make it clear that that was my view. When somebody said, 'Can we afford tax reform?' I answered by saying: 'It's a question of how much. Yes, clearly, we can afford some changes to taxes or expenditure, or to some mix of the two; it is simply a matter of what is the right amount.' I was trying to pour a bit of cold water on the idea of having really big tax cuts and a big fiscal expansion. But I could not say, 'You can't do anything,' because I knew that taxes were coming in so strongly that there was room to give some of them back. Unfortunately my answer was completely misinterpreted. It was interpreted as saying, 'You should go out there and have a big fiscal stimulus.' Or, if it was not expressed that way, it was expressed as, 'You should go out there and have really big tax cuts.' It was quite interesting that it was interpreted that way.

Now we have a position where a lot of people—in fact, sometimes the same people who were urging the really big fiscal stimulus—are going out there and saying, 'It was irresponsible in the last budget to have a fiscal stimulus.' I see that even now my words are being used by the Treasurer to say, 'But I was urged to do it by the Governor of the Reserve Bank.' It is a very funny game we play here on fiscal policy, and it is a game. By the way, I stand by those words that were quoted in the interview I gave. It has been a very good period for monetary policy, in that fiscal policy has not been a problem. I have been lucky in having had a number of years where fiscal policy has just been a small surplus and the change from year to year has been minor, so it has not been a consideration in formulating monetary policy. That part of the statement is absolutely true.

We are now entering a slightly different period. We are now entering a period, as I said, where there are capacity constraints, where we really do not want the economy growing much faster than the twos to threes. The economy is in a situation where it is more sensitive to what happens with fiscal policy than it has been in the past. In our statement we said: 'Our best guess was that, if the federal budget outcome is as it is budgeted, that would be equivalent to a fiscal stimulus of half a per cent of GDP. If we add up all the state budgets that would be another half a per cent of GDP. If you put the two together, that is something that really could not be ignored. If you put the two together and you have a one per cent stimulus, that is something that is now starting to get into the realm where it is relevant for monetary policy.'

I want to make two observations about that. The first one is that at the federal level the stimulus may not eventuate. If this year is anything like the previous years, we will discover that the taxes are coming in faster than the forecast and that the expected change in the fiscal position of half a per cent may not eventuate. It may be another year where, if the government just sits on its hands, the fiscal stimulus will not eventuate. So the stimulus that is coming from the federal area may or may not happen.

In the state area, however, I think the states are pretty determined that they do want to spend the money and they do feel that they need to make additions to their infrastructure. I think the states are going to find it difficult to actually complete some of their projects. We know the private sector has had to abandon a number of projects it wanted to do because of this difficulty of getting the resources, the equipment, the skilled labour and all the rest—they have the money; there is no question about that. Now, if the states are going to be competing against it, I think the states will probably discover, just like the private sector has, that some of the projects may not get off the ground and that some of the ones that do get completed will be completed at much higher cost than they were envisaging. So I think that the combined effect of the state and the federal governments—with the proviso that the federal stimulus may not come through at all—is that, if they did come through as budgeted, it would have some inflationary impact.

Mr FITZGIBBON—I want to continue along those lines. You have indicated that the Treasurer does like to rely on his interpretation of your advice. I assume from the tail end of your statement just now that you are saying that it is too early to know, really, whether there is room for more fiscal stimulus by way of tax cuts in the next budget.

Mr Macfarlane—Yes, it is. It is way, way too early. In fact, purely from our perspective, I think there is one option, which is that you do nothing, and it is quite possible that taxes will come in faster than expected, in which case you do not have much fiscal stimulus. The other possibility is that, if they do come in faster, there may actually be room for tax cuts that do not add any fiscal stimulus because all you are doing is offsetting a contraction. So at this stage of the game we do not know what the right outcome will be, other than to say that I think the government will have a fair bit of control over the outcome. It is not as though what was said in the budget just automatically has to happen. I think there will be a number of decisions that can be made as the year unfolds that could have an impact on whether there is the sort of stimulus that was envisaged in the budget or less stimulus.

Mr FITZGIBBON—Going back to inflationary pressures, you have effectively said—and I hope I am interpreting you right—that it is more likely we will have an interest rate rise again some time soon rather than not. I do not want to tease this out too far, because it is not responsible to be pushing you too hard, but when you have a look at all the pressures involved here—and if you wanted to put them in order of priority as you note them in the statement: the global economy, credit growth, the state of the labour market and then possibly physical infrastructure—there is not a whole lot to be optimistic about, is there, given your comments on the global economy? There may be a touch of optimism on consumer sentiment but certainly no optimism on the labour market and, given it looks as if companies are planning wind back their capex next year, not a lot to be happy about.

Can you make some comments on the labour market. Do you spend much time differentiating between workforce shortages and skills shortages, and what can be done in the future? Isn't it true to say, given the lag effect of any investment in skills, that what needed to be done should have been done a long time ago?

Mr Macfarlane—I think you are trying to get me to become an instant expert on training and education, and I am afraid I am not. I do not profess to be so. I think all I can give you is the same answer that I gave Dr Emerson, which is that at the aggregate level it has not been a cause for concern for us yet, and it may not be. On the employment side, I think we should not get too carried away with the last three, four or five months employment data, because history seems to show that in that monthly employment series you tend to get a run of strong figures and then a run of weak figures that can run for six months or so. So I would not extrapolate from the last four or five months employment figures. I think employment is doing quite well, but in underlying terms it is not growing as fast as the last four or five months have indicated.

Mr FITZGIBBON—I am assuming that you have looked at the projections on capital expenditure. Is your instinct that companies believe they are now catching up, they are now getting to the capacity where they need to be, or do you think that they are more concerned about finding the labour required to utilise that physical infrastructure? In fact, do you believe in the figures as they have been displayed—that the drop-off in the investment spike has been so large?

Mr Macfarlane—Those figures have always required quite a lot of interpretation. As you are probably aware, the first figures always underestimate what is done. The fact that the early figures are not particularly strong normally does not give us much cause for concern.

Dr Edey—The position is that over the last year capital expenditure has grown by 19 per cent, and it has been growing at 15 per cent per annum for a few years now. We do not think it is going to keep growing at that place, but it will still stay strong. I think that view is consistent with the expectations survey that you are referring to, which is still running well ahead of the same survey a year ago.

Mr FITZGIBBON—You are saying that it is coming off a very high base, but I have seen projections of negative figures. Can you have a go at answering the question? Is it because firms believe that they are now reaching the capacity level they have been looking for or is it because they are concerned about their capacity to utilise that additional infrastructure?

Dr Edey—I do not believe we are heading for negative figures for investment growth. You can get some very low figures if you use very mechanical applications of realisation ratios, which is what some of the technical economists use. But if you had applied that method in the two previous years you would have come to a similar conclusion that there was going to be a drastic slowdown in business investment, which did not turn out to happen. As I said, it is still growing at 19 per cent. My reading of those figures is that the expectations now, compared with where the expectations were a year ago, are running well ahead of that year ago level, and that is consistent with our general view that business investment will remain pretty strong but will not keep growing at the same pace that we have seen in the last year or so.

Mr FITZGIBBON—Does the government now face a dilemma on the fiscal front, in that any attempt it would take now on the fiscal front to address either skills shortages or physical capacity constraints, like a One Nation type project, would only wash more money into the economy and therefore further fuel inflationary pressures? Therefore, do we have a right to be pessimistic? Given the delay in taking action, do we now find ourselves in a catch 22?

Mr Macfarlane—It does not necessarily follow that you cannot increase expenditure. If taxes are rising faster than is expected, which has been the case for the last four or five years, that does not rule out expenditure increases.

Mr McARTHUR—I want to go back to the tax argument. Some commentators are suggesting that the $37 billion tax cuts over four years are quite inflationary. On the other hand, the Treasurer has tried, in my view, to overcome the problem of bracket creep. Some people would argue that Australian taxpayers are in the same position, relatively, because of the impact of bracket creep. How much impact do you really think that tax cuts have had on the economy and on bringing inflationary pressures? Would you comment on the dilemma that, on the one hand, the central banks are always nervous, as I read it, about tax cuts, but, on the other hand, Australian taxpayers are quite keen to get a tax cut.

Mr Macfarlane—It is a big question because a lot of tax cuts are certainly not stimulatory. A lot of tax cuts are in fact returning, to the taxpayer, money that came in in excess of what was budgeted for. I do not know where the figure of $37 billion came from, but it is quite possible to come up with very large figures for tax cuts which sound alarming from a macro-economic perspective at first sight. But, if they are spread over a number of years and there is a lot of other underlying growth in the economy occurring and a lot of taxes coming in, these really large figures may not necessarily result in an excessive fiscal stimulus. I cannot tell you anymore than that. I think that, politically, it is in the interests of the government to always come up with the biggest number that you can honestly come up with, but that does not mean all of that number is going to affect the economy. I think you have to do a lot more sophisticated calculations to work out what part of that is actually going to feed through into a fiscal stimulus. When you say you have cut by $37 billion or something, it is $37 billion more than it would otherwise be. There are also a lot of taxes coming in year by year just because the economy grows. I am having a bit of trouble answering this one, because I think I have been given a figure which—

Mr FITZGIBBON—You have got to watch those government figures!

Mr Macfarlane—is not really the figure you would look at if you wanted to calculate the fiscal stimulus.

Mr SOMLYAY—Would you expect tax cuts to reduce household debt?

Mr Macfarlane—Household debt?

Mr SOMLYAY—Yes—to feed into savings.

Mr Macfarlane—I do not know. Malcolm, you have a go at that one.

Dr Edey—Mechanically, it just adds to household disposable income. So, all things being equal, households have got more money available to either repay debt or spend. Presumably, they could do either of those things.

Mr McARTHUR—My next question is in relation to the industrial relations background to the economy, given the resources boom in Western Australia and the demand for labour, and the high prices in Perth which are reflecting that. Historically in these types of economic conditions you have had a wages break-out because of the more centralised wage-fixing system. Do you think the more flexible industrial relations approach that has been adopted in recent years has been helpful in controlling the wages break-out, and would you care to comment on the AWA approach in the mining sector which again might have been helpful in stopping this quite extraordinary demand for labour and wage escalation?

Mr Macfarlane—I am going to hand this one to Mr Stevens but, before I do, I am going to make the general observation that, yes, your point is correct: the gradual deregulation and decentralisation of the Australian labour market has been an enormous benefit and has enabled Australia to withstand this sudden rise in commodity prices or the terms of trade much better than it has in the past. But when I say 'deregulation and decentralisation' I am referring not just to very recent measures; I am referring to things that have been occurring over the last decade or two.

Mr Stevens—You have already given the answer, I think.

Mr Macfarlane—I just gave them the easy bit; you have got to do the difficult bit!

Mr Stevens—I do not think there is any doubt that the whole raft of changes to the way the labour market works, over probably 15 to 20 years now, has changed the dynamics of the way the economy responds when we get a sector-specific shock like the one we have had.

I think you are right to point out that, under the old system, the risk would have been that particular sectors that were confronted with a change in the bargaining position of labour would have extracted some quite large increases and then, through the centralised system, the risk would have been that that spread across the economy. We know that that happened in some key episodes in the past. That does not happen to anything like the same extent today because of all the changes that have taken place over many years under this government and the previous one, so I think that is a correct analysis.

I would add that we do see wages rising faster in the mining sector than in the other parts of the economy, but this is a relative price change that is occurring. It is what you want to happen, actually. You want the areas where labour, and capital for that matter, are in most demand to see a price signal and the labour and capital resources then start to flow to those industries. By and large, that is what is occurring. I would just say again: the economy does cope these days much better with that kind of a shock than it once would have. I think labour market reform over quite a long period has been an integral part of that better adjustment. On AWAs, in particular in the mining sector, I do not know sufficient about the structure of those agreements to offer much useful comment. The only comment I can offer is a more general one.

Ms GRIERSON—Taking up the issue of wage behaviour, wage behaviour has been described in this period of incredible continuous growth as stable, almost subdued. It is pleasing to hear you acknowledge that, in part, it has been due to a long-term process in the regulation of the labour market. In terms of how that is looked at, though, the sectors that have had massive growth tended to be ones that have highly unionised workforces—construction, mining et cetera—and the wage growth is often managed in steps or in other forms of payments such as bonuses, location bonuses, housing and services to employees. Is that now impacting on how we measure the labour market and the impact of wages on the economy? Are wages delivered in very different forms and therefore—while it may be a very good thing; it may be offsetting the growth that could come in wages—is there now a measurement problem with wages?

Dr Edey—The Statistician does attempt to measure those things in the labour price index, so the figures that were quoted earlier were for just the core wage measures which are running at about four per cent. There is a broader measure that the Statistician calculates that includes bonuses and these additional costs and that particular measure has been substantially revamped just in the last two quarters. So it is difficult to get a consistent series for that. There is an experimental data series available for that and that seems to show that the broader wage measure that includes these other things has been running at about half a percentage point faster than the core measures. That gap does not seem to have been rising in the last year or so, but that half a point gap probably should be taken into account in the way we think about wages.

Ms GRIERSON—I know that, for the Reserve Bank, monetary policy is your tool but fiscal policy is our tool and we cannot avoid it. We have talked about the fact that consumer spending continues to grow. Even after two interest rate adjustments and tightening, it continues to bounce back. It is also suggested that, obviously, job growth is available, asset prices are still quite healthy and tax cuts were given—and one of my colleagues mentioned $37 billion; that is, the budget figure over four years: $37 billion worth of personal tax cuts over four years.

However, next year is an election year and it is unlikely that governments will sit on their hands. The tax cuts that have been given were aimed at the top end of the market and therefore, as the governor has already said, perhaps did not have the stimulatory effect that might have been anticipated. However, they also show that middle-income earners have not benefited from government spending and tax cuts to the same extent. One would think and predict that governments might want to stimulate that area and spend in a way that will stimulate the middle-income earners' income. What impact would that have, do you think, on the economy?

Mr Macfarlane—I am afraid I really cannot comment on hypothetical guesses about what the government might do in the lead-up to the next election. I am sorry.

Ms GRIERSON—All right. There has not been any discussion today on currency predictions. I would be interested to hear a comment on the position of the dollar, in that its movements are predicted by some to decline, in terms of it decreasing overseas investment into the Australian dollar. Commodity prices are predicted to fall. What are your predictions regarding the currency over the next 12 months?

Mr Macfarlane—I do not make predictions about the currency unless it is at a really extreme level—and it is not at an extreme level now. It is actually at a very comfortable level. I have probably spent less time thinking about the currency in the last year than I have at any stage during my career.

Ms GRIERSON—It has been so strong.

Mr Macfarlane—It has not been that strong. It has sort of been—

Ms GRIERSON—Just where you want it.

Mr Macfarlane—A bit like Goldilocks, yes. By the way, I never said the economy was nirvana. There are a number of things that have been attributed to me in these meetings which I would never have said. I never said the economy was nirvana. I said someone who was an inflation forecaster in the seventies and eighties would think they were in nirvana if they were doing inflation forecasts now. That is a very different thing to say than saying the economy is nirvana. I know you did not attribute that to me.

Ms GRIERSON—No, I did not. I will push that nirvana issue and ask you another question. This 15-year cycle has been quite exceptional and very unpredictable in terms of 'Would this happen ever?' It is not a pattern that we have ever seen before. We are now riding at the top of your inflation target level. Is it acceptable to stay at the top of that level for some time, given this pattern of high growth and given the fact that this could continue or plateau and that we may not see the troughs we have seen in the past but perhaps minor dips in it? Is it therefore more acceptable to be at the top range of the inflation target and to therefore not make those adjustments in quite the same way as one would have if the old patterns were applying?

Mr Macfarlane—I think the answer to that is no. I think the answer is that we still would want to see inflation come down again. Underlying inflation has been higher during this 15-year period. It is not as though we are in an unprecedented situation at the moment. It has been above three, and headline has been higher than it is now too. It is not as though we have entered uncharted waters. The experience we are facing at the moment in many respects is similar to what we have had in the past, other than that I think capacity constraints are biting more now.

Ms GRIERSON—Thank you.

CHAIR—Our only representative from the boom state of Western Australia, Michael Keenan.

Mr KEENAN—Governor, I want to return to the issue of tax cuts. It seems to me that every level of government in Australia is benefiting from windfall taxation. What the Commonwealth have done is we have paid for the services that we are providing, run a healthy surplus and then really returned the excess that we have collected to people, which I think is a perfectly reasonable thing for us to do. But the state governments are also having windfall tax revenues, and what they appear to be doing with theirs is collecting this excess revenue and spending it on increasing their workforce and paying that workforce more. Are there dangers posed to the economy by the states running their fiscal policy in that way?

Mr Macfarlane—I think that is a bit of an unfair characterisation. I think the states by and large have had very prudent fiscal policy over most of the period you are referring to. What we are talking about at the moment is half a per cent of GDP which is earmarked for infrastructure. I have no problem with states spending money on infrastructure. I do not even have any problem with the general principle of borrowing for long-lived assets like infrastructure. My only minor worry is that I wish they had done it a few years earlier. It is a bit procyclical to be doing it just now. But I think overall the states of Australia have been reasonably prudent in their fiscal management over most of the last decade. I would not wish to accuse them of anything other than that.

Mr KEENAN—I will move on from that. Given that the latest rate rise was in part in response to factors such as oil prices and bananas, what would have been the consequences of waiting for those factors to clear through the economy before raising rates? What made you jump now?

Mr Macfarlane—I did not like your premise there. You said ‘given that it was partly in response to oil prices and bananas’—it was not. Basically our assumption is based on our measures of underlying inflation, and with the way we calculate underlying inflation both of those things would be taken out, along with a number of other things which perhaps had fallen by a lot. Our decision was not based on that. We knew long before this CPI came out everyone was going to be talking about bananas. We actually know what the price of bananas is, and we know that that will probably make a zero contribution to this quarter’s CPI and that the quarter after that they will make a big reduction in the CPI. It was known almost the moment that the cyclone hit that there was going to be that pattern. We have spent years and years analysing inflation and working out how to separate the underlying component from the froth and bubble on the surface.

Mr KEENAN—Finally, do you think it is reasonable for the banks to pass on these rate rises the following day?

Mr Macfarlane—Yes. They should pass on rises and falls. I think we have done some work on that. There used to be a problem but there is not a problem now. Is that the answer?

Mr Battellino—Yes, that is right. The response of banks to changes in the official cash rate is pretty symmetrical these days. I do not think there is any issue there at all.

Mr CIOBO—Governor, I am mindful of the fact that you said you had barely turned your mind towards the Australian dollar and foreign exchange. I read in today’s paper that you made a tidy profit of about $3 billion. I am hoping you have passed on the secrets of that success to the incoming governor, Glenn Stevens. That is just an aside.

Given your understandable sensitivity to being misquoted, the *Australian* on Saturday, 12 August stated that Governor of the RBA Ian Macfarlane has rejected suggestions that the May 2005 federal budget was ‘highly expansionary’ in adding pressure to interest rates. In February 2006 the member for Rankin asked you whether tax reform was affordable and you said yes. You went into more detail today about how some changes to taxes were affordable. I asked you in August 2005 whether fiscal policy had been a significant influence on whether or not to raise interest rates and you replied:

> Fiscal policy has not been a significant influence on monetary policy at all in Australia for the last six or seven years.

Generally, in February 2006, when questioned about the likelihood of tax cuts in the May 2006 budget, you made reference to the need to maintain a surplus. You said that over the last six years it has been somewhere between a half and 1½ per cent of GDP and that it has not moved very much in that range. Given all of that background, if there were future tax cuts that maintained a budget surplus in that range that largely were viewed as keeping within the parameters you have outlined today, would that be acceptable and would it have much impact on monetary policy?

Mr Macfarlane—First of all, if I can go back to your first, throwaway, remarks about the profits made from foreign exchange, it is true the Reserve Bank have made significant profits from foreign intervention in the Australian dollar market, not because we set out to do that but simply because we set out to be stabilising. It is very nice of the journalist to attribute it all to me, but of course it is not—it is a much wider group of people who have been involved in that, including Mr Battellino, who has had a very important role in that and will continue to.

On the second issue, I think you are right in saying you should not look at tax cuts by themselves or add up the value of the tax cuts. What you really want to look at is the budget in totality; and, in totality, the crucial figure you want to look at is the fiscal impact, which is the change in the surplus or, if it were a deficit, the change in the deficit. And if you make tax cuts that do not have a significant fiscal impact then one cannot say those tax cuts are inflationary.

Mr CIOBO—So: maintenance of a budget surplus in the range you have indicated.

Mr Macfarlane—It is not a matter of whether it is surplus or deficit. It is the change in the surplus. A big fall in a surplus would be expansionary.

Mr CIOBO—That is my point: the maintenance of it within that range.

Mr Macfarlane—Yes, within that range.

Mr CIOBO—That is the point I make.

Mr Macfarlane—I am not sure whether I would say maintenance within that range. That is a little bit broad. If you went from 1½ to half in one year, that would be a one per cent fiscal stimulus. If you did that I think that would definitely have a measurable impact on the economy.

Mr CIOBO—Okay. With respect to the announced changes in tax rates, the impression I had was that you said in isolation that was worth about 0.5 per cent of GDP. I think those were your remarks: that in isolation that probably would not have placed pressure on the inflation rate, but that coupled with a 0.5 per cent stimulation from state budget deficits that has had an impact on the inflation rate. I am mindful of the fact that state and territory governments are forecasting fiscal deficits of $5 billion in 2006-07 and are budgeting for increases in borrowings to raise state government net debt to $43 billion by 2009-10. Does this effectively mean that the hands of the federal government are tied if we are not going to unduly stimulate the economy as a result of this state government borrowing and debt?

Mr Macfarlane—All I can do is reiterate my earlier position, which is that for a number of years now the budget has been in surplus but it has envisaged a small reduction in the surplus, so the budget has envisaged a small fiscal stimulus. By and large, in each year it has not eventuated because taxes have come in faster than expected. So the initial size of the stimulus—say it is half a per cent—is sort of on the borderline of whether it would be something you would want to take into account. But given that you knew that there was a probability that it was not going to eventuated anyhow, that gave you a second reason for not really thinking that it was big enough to influence a monetary policy decision. That part remains. Basically, at the Commonwealth level what has happened in this budget is very little different to what has happened in the previous budgets: a small fiscal stimulus is budgeted for, which may or may not occur; and even if it did occur it is half a per cent—it is on a sort of borderline of whether it is something you would want to take into account. The thing that is different this time is that, in addition to that, there is another half a per cent coming from the state governments. So if the federal one does eventuate, which it may or may not, and the state ones eventuate, which we think they will, then you are talking one per cent. And one per cent fiscal stimulus in an economy which is going to be growing three per cent is significant.

Mr CIOBO—That is what I was seeking to clarify. The comments you made earlier left me with some uncertainty as to the size of the fiscal stimulus as you saw it. So from a federal perspective, in terms of the last budget, you are saying the fiscal stimulus was minor and that it has been exacerbated now by the additional 0.5 per cent from state government deficits. Is that correct?

Mr Macfarlane—Yes. A half and a half equals one.

Mr CIOBO—Sure, and hence my concern as to whether the federal government's fiscal policy is constrained because of state government borrowings and debts expanding so significantly over coming years. It would be logical, would it not, in accordance with the parameters you have laid out, to say that this large stimulus at a state government level, even though it is increasing capacity, will have impact on fiscal policy from a federal government perspective?

Mr Stevens—But it would be equally valid to say that, were we to get half a per cent of GDP unexpected growth from exports—

Mr CIOBO—Sure. That would ease the pressure.

Mr Stevens—the federal government's position would be constrained exactly the same way, on that logic. I am not sure where this takes us. All it leaves you with is this. Any federal government that is thinking about fiscal policy has to take into account all the other things that are happening in the economy when it makes its decisions. We know that state government budgets turn out to be, perhaps, one of those things on occasion, but there is a host of other things and we and the government have to take all those things into account. That is not really a new thing.

Mr CIOBO—Finally, with respect to labour force shortage—and despite the member for Rankin verballing you and saying that you said it was a skill shortage you actually say 'shortages of labour'—

Dr EMERSON—So there's no skills shortage?

Mr CIOBO—you make a specific remark on immigration and the role that immigration has played in assisting to meet this labour force shortage and, by default, part of the skill shortage. I would be interested in your comments on this: if there was a measure that sought to reduce skilled labour coming into the country, if there was a proposal to reduce the labour force that Australia is currently importing from abroad, what would you expect the impact of that to be on inflation?

Mr Macfarlane—I think a reduction in skilled immigration would be unhelpful.

CHAIR—We will leave the other questions for after morning tea. We have two questions from students. We are very pleased to have various schools represented here. I would like to invite the School Captain of Woolooware High School, Nathan Lyons, to come and ask the first question, followed by Craig Holland of Gymea High School. You may all be interested to know that Woolooware High School is the former school of the incoming governor.

Nathan Lyons—Good morning. Governor Macfarlane, as HSC students we learn about economic objectives and the role of micro-economic policy in achieving those. We have watched with probably naive perplexity as the fiscal policy of this year seems to be expansionary and now we are pursuing a contractionary policy in micro-economics. Exactly how autonomous have you felt in your time in pursuing the micro-economic policy of this nation?

CHAIR—Did you help with that question!

Mr Macfarlane—I have felt very independent. I think the agreement that I entered into on behalf of the Reserve Bank with the government in 1996 has been adhered to. I feel very strongly that the government has kept its side of the bargain and has not attempted to influence the decisions we have made on monetary policy, even though I know it has disagreed with some of them. It has publicly expressed its disagreement, but that has not troubled me at all.

CHAIR—Thanks very much.

Craig Holland—Governor Macfarlane, Australia’s foreign debt continues to rise and has risen rapidly in recent years. The interest and dividend repayments on this debt now comprise by far the largest proportion of Australia’s current account deficit. Does the Reserve Bank see a role in monetary policy for reducing Australia’s external problems?

Mr Macfarlane—I think that the fears about foreign debt which were very widespread 20 years ago and 10 years ago were overstated. I think that the measure which is most widely quoted, which is foreign debt as a proportion of GDP, makes the situation look worse than it is. I think every form of debt when it is compared to income usually always rises, whether it is household debt or business debt. I think the more meaningful comparison is the value of debt as a ratio of the value of Australia’s assets. If you look at that particular measure, we are actually reasonably stable. And particularly when you take into account that the fact that we have been able to borrow and have been able to use international savings has enabled the economy to grow much faster and has made it a much bigger economy, I think the cost of wanting to reverse that would be too high and would be unwarranted.

CHAIR—Thank you for your participation. We hope to have time for one or two more questions from schools, depending on how we go in our next session.

Proceedings suspended from 11.26 am to 11.53 am

CHAIR—Governor, we will resume our questioning. Obviously, we have less time now, but we would like to run through some of the issues. I would like to come back to the question of housing and home lending. The RBA has made mention of the fact that there has been a compression of lending margins so the commercial borrowing costs are below the cash rate. This seems to have acted to stimulate borrowing for housing. For how long would you see this situation as likely to occur? The clearance rates of home sales seem to be rising, and I know that investment in housing has been one of your particular areas of interest. Do you see this as an early sign of recovery by the housing sector on the east coast, or do you think it is a false dawn?

Mr Macfarlane—On the housing cycle: borrowing for housing has certainly picked up. It slowed for quite a while, reached a trough in about September or October last year and has picked up since then, so the borrowers have come back. House prices probably came back a little bit in the first two quarters of this year. Of course, they are booming in Western Australia, where they have hardly slowed at all. In the eastern states they have come back a little bit but not a lot. On house building: it is down from its earlier peak, by 17 per cent. The other interesting thing that is happening, as you said, is that vacancy rates have come down. Rents, if anything, are starting to creep up. The big correction that occurred during 2004-05, when house prices came down and lending slowed, seems to have finished and there is a slight movement upwards occurring.

CHAIR—Do you think this is likely to be sustained or is it just a short period of sunshine?

Mr Macfarlane—I do not look upon rising house prices as a period of sunshine. I know that most people do, but I do not, and certainly not if they are rising very quickly. I do not think we will get back to what we had in the early part of this century, when we had excessive rises in house prices. I do not think that will happen. The interesting thing is that what appeared to me to be a massive oversupply has been pretty well used up, if the figures on vacancy rates and rents are to be believed.

CHAIR—I shift to the international scene and would like to look at some of the headwinds that the US economy is facing. How do you see the US economy performing in the next few years? Considering its impact on the rest of the global economy, do you see any concerns for us if the US economy falters?

Mr Macfarlane—I think the US economy will slow a bit. I think everyone agrees with that. It has been growing pretty fast. The Fed wants some slowing. I think some slowing is in order. The sector that people are looking at, which has clearly slowed, is house building. Their figures were smaller than ours, but they had a big rise in house prices and some speculative activity in the housing sector. One cannot be surprised when one looks at how low their interest rates were. That seems to be coming to an end. Even though the slowing in the US has a big influence on financial markets, because financial markets tend to take their lead from the US, I think the world economy as a whole is still going to be reasonably buoyant. Europe's economy is now growing at the fastest rate for six years. Japan, as we know, has got back on track. China is still growing strongly. As I have said to this committee on a number of occasions, the parts of the world that we do not to tend to follow—Latin America, the former Soviet Union, the Middle East, and those sorts of places—are doing pretty well. Emerging markets in general are doing well. A very good adjustment has been occurring. For most of them, their inflation rates have come down and their ability to borrow has improved. My perspective is that the expansion will continue, but that does not rule out the possibility that the speculative activity in commodity prices might wind back. Overall, I think the world economy is in reasonably good shape.

CHAIR—On the US economy, with regard to the 17 straight increases in interest rates, which have now paused, do you think that was appropriate, given the changes in oil prices, the world economy and the strengthening of Europe and Japan?

Mr Macfarlane—I certainly was very happy to see the 17 increases, because I thought their starting point was just so low it was very risky. As to the fact that they did not move last month or whether they are going to do so next month, I do not really wish to speculate on those very short-term movements.

Dr EMERSON—You have just said, Governor, that you do not look on rising house prices as sunshine. There are macro-economic reasons for that, but is another reason for that that it affects affordability? Could I refer you to page 22 of the statement on monetary policy, where it says:

> Despite the expected growth in disposable income, the household debt-servicing ratio is likely to rise further in the period ahead, since household debt has been growing at an even faster pace than income. Together with the recent increases in interest rates, this is likely to boost households' interest payments.

So is there now an issue of affordability in the historical context?

Mr Macfarlane—I do not think there is anything particularly interesting happening just at the moment. I think there is a bigger story, which I will mention because you have heard me talk about this many times in the past. There seems to be an enormous amount of focus in this country on interest rates, as you know. I think I presented some evidence in a recent speech that our press spends more time talking about interest rates than any other press. And of course whenever we put up interest rates I always get lots of letters and emails saying how much hardship we are causing people, particularly those people who have just bought a house and have got a lot of debt, or those people who are wanting to borrow some money. There is huge emphasis on, 'It is going to cost you X amount more per week because interest rates have gone up by a quarter of a per cent or half a per cent.' And the assumption behind this is that that is the thing that young people really dread, that the worst thing that could happen to them is that interest rates go up. In fact, I think there was a great headline before the May increase: 'Your worst nightmare'.

I want to make the point that there is a much bigger problem for people than interest rates going up, particularly if we are concentrating on young people who have just bought a house or who have a young family or are trying to buy a house. The biggest problem for them is not interest rates; the biggest problem for them is that houses are so expensive—they have gone up so much in price.

The increased outlays because of the two recent interest rate rises you can calculate in various ways, but on the average mortgage they have added $540 a year to the cost of servicing the average mortgage. If you have just bought a house and you have bought the average house and you have 85 per cent borrowing, then it is adding more—it is adding $1,700 a year. But these figures are actually tiny compared to the extra cost that you have to incur to buy the house, because the house has doubled in price over the last 10 years. To buy the same dwelling as you could have bought 10 years ago is going to cost you $200,000 more. That is really a huge number, compared to the changes in interest rates. Interest rates of course are lower now than they were 10 years ago, but the price of a house has doubled. And for someone in their 20s or early 30s, the age group probably most vulnerable to the effects of housing, either through housing prices or through interest rates, it is the big increase in the house price that has been the killer. That is the thing that has affected affordability, not the interest rate. And yet we concentrate almost exclusively on interest rates, as though the interest rates are the bad guy, and we often think of rising house prices as though somehow or other that is a good thing.

Dr EMERSON—But it means, does it not, that overall mortgage interest payments are now—because of the housing affordability issue, that house prices have gone up in the way that you have said—pretty high by historical standards?

Mr Macfarlane—Yes.

Dr EMERSON—I guess that is the question: are they high by historical standards?

Mr Macfarlane—They are. That is caused more than 100 per cent by the fact that house prices have gone up, not because of interest rates going up. Interest rates are lower than they were 10 years ago and are obviously lower than they were 15 years ago.

Dr EMERSON—But affordability is no different?

Mr Macfarlane—The story is all about house prices. The story is not about interest rates. Yet, if you read the press you would think interest rates were the only thing anyone was interested in.

Dr EMERSON—Can I move now on to the question of skill shortages. I do need to respond to the suggestion of the member for Moncrieff that I am making something out of skill shortages that the Reserve Bank is not. I checked during the break, and skill shortages were raised as a concern in each of the last five Reserve Bank statements on monetary policy and in fact were first raised back in 1999. Can you advise whether skill shortages are one of the capacity constraints to which you have pointed in the various statements as contributing to some of the economic issues that we confront today?

Mr Macfarlane—The answer to that is yes.

Dr EMERSON—Thank you. I am now really moving on to some of the aspects of fiscal policy. You said a little while ago that the states were now investing in infrastructure but that you wished they had done it a little earlier so they were less procyclical, if you like. Would that also apply to investment in skill shortages by the Commonwealth?

Mr Macfarlane—I do not know enough about that to answer that one, other than to say that most things are procyclical. Most things that the private sector does and the government does end up being procyclical. Our job is to be anticyclical.

Dr EMERSON—It seems to me that you are saying that the same considerations, with respect to capacity constraints, apply to skill shortages as infrastructure.

Mr Macfarlane—I really do not know enough about it, other than to make the general observation that—whether it is physical capacity, skills or whatever—you do not normally get energised to do something about it until the shortage is already there. In that sense, most things are procyclical.

Dr EMERSON—Is that the recent Australian story?

Mr Macfarlane—It is not just an Australian story; I think it is the nature of a free market economy that most things become procyclical.

Dr EMERSON—I would like to bring into the conversation the Deputy Governor if I could.

Mr Macfarlane—Willingly, yes.

Dr EMERSON—We talked earlier about income tax cuts. I was the member of the committee who raised the question of income tax cuts in the February hearings. The question I asked was whether tax reform was affordable, and I remember you answering, 'Yes, tax reform is affordable.' Yet, in the statement on monetary policy of 4 August, the tax cuts that were granted in the budget are raised twice, on pages 2 and 22, as factors contributing to strong domestic demand. Can either of you elaborate on the role of tax cuts? When you do have strong domestic demand, under what circumstances can tax cuts be affordable? Could I suggest this to you, perhaps as part of the answer. If the tax cuts are directed at improving labour market participation—that is, removing obstacles to moving from welfare to work and/or increasing hours of work for people who are already in work—does that actually ease some of the capacity constraints so that tax relief, when it takes on that form, might be affordable?

Mr Macfarlane—Can I start by going back to what I said. You have done the same thing as everyone else: you have left out the start of the sentence and the end of the sentence.

Mr CIOBO—He does that!

Mr Macfarlane—First of all—it was your question; you asked it—you did not ask, 'Can we afford tax cuts?' You said, 'Can we afford tax reform?'

Dr EMERSON—That is what I just said.

Mr Macfarlane—I know. Obviously, you can always afford tax reform if you do it in such a way that it has zero fiscal impact. You can always afford that. Even so, the whole tenor of what went before was really about tax cuts. My answer was:

It is a question of how much.

That is the first reference to that.

Yes, clearly we can afford some changes to taxes or to expenditure or some mix of the two. It is simply a matter of what is the right amount.

It is mentioned a second time. There are three thoughts there, one of which is repeated, at the beginning and the end, and there is another bit in the middle. Everyone has concentrated on the little bit in the middle and tried to leave out the bit at the beginning and the bit at the end. I just want to re-emphasise that I was not arguing for major tax cuts. I was certainly not arguing for anything like that. I was trying to hose down—pour a bit of cold water on—the enthusiasm that was building up prior to the budget, where all sorts of people were demanding very big tax cuts. Now you can answer the difficult bit, Glenn!

Mr Stevens—My interpretation of the second part of your question is: if we have decided to do tax cuts, does it matter how they are done? I guess the answer to that has to be that, in principle, that can matter. A reasonable case can be made that those welfare to work issues, the high effective marginal tax rates and so on, are important things that can be considered. I do not think it is for us to tell you or the government how they balance that with other objectives they may have. These are things that have to be decided in the political world. That is the job of the parliament, not us. But I think it is a reasonable thing to say that those high effective marginal tax rates are important considerations in the kind of structural way that the labour market functions. That seems to me to be right.

CHAIR—In the interests of making sure that everyone gets another go at questioning, I call Mr Ciobo, before he has to leave.

Mr CIOBO—Governor, I would like to touch on some of the comments you were just making about housing affordability. In particular, I guess I would like to try to be a little more precise. As I understand it, construction costs for housing have basically not altered too much in real terms in relation to the cost of housing, but what we are seeing—or so I would assert—is that it is a land affordability issue. I invite your comment on that as point No 1. Point No. 2, from an economic perspective, is: if reform was sought to make land affordability better—for example, stamp duty relief or perhaps a greater supply of land from a greenfield site—do you believe that would be in the interests of the Australian economy?

Mr Macfarlane—There are two questions underlying your one question. The first question is: why have the prices of the eight million houses in Australia basically doubled over the last decade? The answer to that one, I think, is almost entirely on the demand side. Basically, because we returned to low inflation, interest rates were halved. People could now borrow, if they wished, twice as much. They did not have to borrow twice as much; they could have taken it in lower debt servicing if they had wanted to, but there were a whole lot of incentives in the system that meant they borrowed twice as much. The incentives were mainly tax incentives, plus a history of high inflation. So they borrowed the money and drove up house prices, so the whole stock of eight million houses basically doubled in price. That is the answer to the first question.

The second question is a more interesting one—that is, why has the price of an entry-level new home gone up as much as it has? Why is it not like it was in 1951 when my parents moved to East Bentleigh, which was the fringe of Melbourne at that stage, and were able to buy a block of land very cheaply and put a house up on it very cheaply? Why is that not available? Why is that not the case now? I think the answer to that one is what you are alluding to. I think it is pretty apparent now that reluctance to release new land plus the new approach whereby the purchaser has to pay for all the services up front—the sewerage, the roads, the footpaths and all that sort of stuff—has enormously increased the price of the new, entry-level home. That is a supply-side issue, not a demand-side issue. I think there is a lot of evidence that, at the moment, those factors are becoming very important.

One of my pieces of evidence for that is the fact that vacancy rates are going down, rents are starting to creep up and people say—and I do not know how much trust I can put in this—that we are not building enough houses at the moment and are not quite keeping up with demographic demands. Why should that be so? Is it because of a lack of demand? It certainly is not, because the demand really comes from people borrowing money to buy houses, and they are borrowing money. That is growing quite quickly. There is no blockage on the demand side, so it has to be on the supply side. 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 do not want to prejudge it but I think there is increasing attention now being focused on that.

Mr CIOBO—A very interesting point. I am keen for an update on the reforms to the payments system and any response, if you have one, to this committee's report on our inquiry into the payments system.

Mr Macfarlane—I was not at the committee meetings but I have read the report, which I thought was an excellent report. I also think it was an excellent idea on the committee's part to bring all the parties in at the one time, listen to them all and subject them to having to listen to their rivals' points of view. That was a very good idea. As I said in my introductory remarks, I thought that was a great success and I thank the committee for doing that, because it was quite a big meeting—a two-day meeting. It was a lot of work.

In terms of the progress of where we are, the major things we have on our agenda are that by 1 November we will have received all the data from the issuers in the EFTPOS system and we will move to the new lower interchange fees on EFTPOS and, at the same time, the new lower interchange fees on the Visa debit card. Our three years will be up for the credit cards and we will look at the new data on credit cards, but my understanding is that it is unlikely that anything much will have changed there. So the two changes that are in the offing are the reductions in the interchange fees on EFTPOS and on Visa debit. Do you want to add anything to that, Phil?

Dr Lowe—No, that is right. I would like to reiterate the governor's comments about the value of the hearings. I thought the quality of the questioning that we had and the discussion were really first rate and really reflected the time that the committee had put into understanding what, in the end, are very technical issues. We thought that process worked very well. I also think the committee hit on the right issue on the technology of the payments system. That really relates to the committee's recommendation that the industry look at PIN on credit cards, on the introduction of chip and what has been called 'online EFTPOS'. Going forward, those technology issues will really shape how our payments system evolves, and I think the committee was right to focus on those. In terms of other issues, we are still discussing ATM reform with the industry. That process has been going on for a number of years and the industry has recently given us another discussion paper. While there is hope of an industry based solution emerging, we are prepared and happy to give the industry more time.

Ms GRIERSON—The monetary statement talks very much about the global economy shaping our economy. I seek your comments on the future growth trends in terms of the Chinese economy and its actions to keep the balance between domestic growth and export growth in a way that saves China from having to dramatically change its policy. I would also like your comments on the view that the demon that we all once saw globalisation as may have become a very responsible way of integrating economies and making globally responsible economies much more possible.

Mr Macfarlane—We are still pretty confident that the Chinese economy will continue to grow at very high growth rates. I do not know exactly what it will be. In fact, most people who look at Chinese economic statistics now think that they actually understate the amount of growth that is going on. Five years ago people used to claim they were overstating it; now most people think, if anything, they are understating it.

As for the fact that the renminbi is still at a level such that they have large surpluses month by month and accumulate more and more international reserves, our view has always been that it is in China's interest to remedy that. We do not preach to them and tell them that they have to do it. And we certainly do not think they have any obligation to do it because the US has got a current account deficit, but we do think it is in China's interest to do it.

I have had a number of interesting discussions with my opposite number, Governor Zhou, from the People's Bank of China, and the similarities between what they are going through and what we went through 35 years ago are amazing. We had a fixed exchange rate. They had a fixed change rate. We then introduced a limited amount of flexibility by having a committee sit down and move it a little bit each day. We had all sorts of capital controls. He is very interested in our experience. In fact, some of the other officials have spoken to our people about it.

Eventually, it is going to happen. It cannot continue going on the way it is. Eventually, they will have to stop accumulating reserves and find a way of raising the value of their currency. The transition process is difficult. So I think we have to be sympathetic to them in the sense that it is a difficult process; but, on the other hand, they will have to solve it over the next decade.

As for your comments on globalisation, there is no doubt that the two biggest economies in the world will gain enormously. China and India have learnt that they will gain enormously from globalisation. For some other countries it presents big difficulties. I think countries that compete by having huge manufacturing sectors are finding it difficult. Australia is in a remarkably good position. This latest stage of globalisation with the emergence of China and India cannot help but be very beneficial to Australia.

Ms GRIERSON—I will ask one more question—which I do not know whether the deputy governor can answer but I am sure that the governor can—because I think there will be an interest in it. It is expected that the Treasurer and the new Governor of the Reserve Bank will have discussions on a new agreement on the statement on the conduct of monetary policy. There have been hints that the Treasurer might be moving towards not just the target of two to three per cent but an overriding goal to maintain a reasonable level of economic activity. I seek your comments on whether you see that negotiation or that agreement varying and whether that would have any impact on the way in which the Reserve Bank operates in terms of monetary policy.

Mr Stevens—I am yet to have that discussion with the Treasurer. On the day that he called me to tell me that he was going to offer me the job, he just said that we will have another agreement and that it will be very similar to the one that already exists. I think that is the right thing to do because, at moments like these, what is important is the continuity of the system when the personnel are changing. The system is more important than the personnel, so we want the system to have continuity. Without wanting to prejudice a discussion that I am yet to with him, I would be very surprised if there were substantive differences to the statement that I will sign with him compared with the two that Ian signed. I would expect business as usual. I think the way that we have been conducting policy will remain the case through the next seven years.

Ms GRIERSON—Governor, do you take that as recognition and acknowledgement of the success of the way it has worked over the 10 years that you have been governor?

Mr Macfarlane—I think it has worked very well. The other thing I should point out is that the agreement endorses the independence of the Reserve Bank, as contained in the Reserve Bank Act. The Reserve Bank Act makes it quite clear that we have obligations not just regarding inflation. We have obligations towards the welfare of the Australian people and towards employment. The best way to achieve those broader responsibilities, as I have said ad nauseam, is to have a long expansion, and the only way you can have a long expansion is if it is a low-inflation expansion. That is why there is no contradiction between having an inflation target and having responsibility for a good employment outcome.

Mr McARTHUR—In view of the fact that this is your last appearance before the committee, that we have a lot young people with us today and that a number of people out in the community think a little bit of inflation is not a bad idea, would you give the committee a philosophical view about the evils of inflation in the Australian economy?

Mr Macfarlane—Some of you may be aware that this year I am delivering the Boyer Lectures, which is a series of six lectures. It has been going for about 50 years. It is on the ABC. One of the themes that will run through the Boyer Lectures is the difficulties that economies have had over the last 50 years in coping with the conflict between the short-term incentives in the system and the long-term incentives in the system. By that I mean that it is always possible in the short term to run very expansionary policies and actually get a bit of an improvement in economic growth and employment but at the cost of higher inflation. So, in the very short run, there is a temptation to run policies that are too expansionary because you get slightly better employment and output growth—but higher inflation.

That short-run incentive is the thing that made economic policy so difficult to run for most of the last 50 years, because we know in the long run it is exactly the opposite. We know that in the long run that gets you nowhere, because in the long run, when you look over the sweep of postwar economic history, the low inflation period is the period when you get good economic and employment growth. We had it in the fifties and sixties, and we have it again now—during the nineties and the first half of this decade. The period of high inflation is the period when you get bad employment performance and economic growth.

So the challenge to economic policy was to find a way where decisions were taken in the long-term interest rather than the short-term interest. That is where, ultimately, we came up with a framework which was based on an inflation target and central bank independence—because that recognises that in the long run the best way of achieving full employment and of having good economic growth is to maintain low inflation. The period of high inflation—the seventies particularly—was a disastrous period. We got nothing out of that high inflation other than higher unemployment and economic instability, and being in government during that period must have been hellish. In fact, being the central bank governor during that period must have been pretty hellish too.

Mr FITZGIBBON—I have two questions about the future which I will direct to the deputy governor. Because of the high levels of debt, a strong feature of monetary policy in recent years has been the fact that you have not had to tweak rates very much to secure the desired impact in the economy, yet on page 40 of the statement on monetary policy you make the point that, because of intense and growing competition in the home-lending market—which is a good thing, of course—last time around some lenders actually reduced their rates. Given that we would hope and assume that competition is going to grow and increase, does this have some implications for the future? Does it mean that potentially in future you will need a larger sledgehammer to get that desired impact? Also, have you had much of a chance to think about the government’s proposals on superannuation, particularly in the context of the ageing of the population? Do you see any future implications for fiscal policy and, therefore, for monetary policy?

Mr Stevens—As you point out, one of the things that we have observed in the pricing of lending over recent years has been some compression of margins. That has basically been a slowly shrinking wedge between the cash rate that we can influence and the rates that people actually are paying. I did not think it is true to say that because that has occurred we need bigger movements, if that is what you meant by ‘a larger sledgehammer’. In fact, I am a bit uncomfortable with the notion of sledgehammers in general here, as I am sure you would be.

Basically what it means is that of the several tightenings that we have done—seven, I think, since the out phase started some four years ago—about one of those has been offset by growing competition and therefore there is compression of margins. I suppose in principle that means you have to think about whether you need to do a little bit more than you would otherwise have done. It is worth saying that there is not really any reason in principle—I don’t think anyway—why competition amongst intermediaries ought to all be given to the lenders. Why not some to the depositors, because after all the price of intermediation services is the gap between what the banks and others borrow at and what they lend at? The compression of margins is just a reduction in the price of the service that they are providing. In principle, there is no reason depositors could not get some of that as well as lenders. Indeed there is some growth in competition in parts of the deposit market occurring.

As far as the superannuation issue goes, you should actually be asking the person who is about to retire because he, I am quite sure, has looked into it more closely than I. But I do not think we are sufficiently expert in retirement income policies and tax policies to offer any comment on the merits or otherwise of those changes. I do think that population ageing will pose challenges for retirement income policies over time in all countries. I think that is ultimately going to need to result in later retirement ages for all of us. I think ultimately that is what it comes down to. But beyond that general comment I do not think I can offer you much on the recent changes per se.

Mr FITZGIBBON—I suppose the question is whether it encourages or discourages later retirement.

Mr Stevens—Presumably, it encourages people to at least wait until 60, so for those who were contemplating retirement earlier than that presumably that incentive goes in the right direction. Beyond that, the set of incentives are more complicated to work out, I think, because it is a much more complex story.

Mr SOMLYAY—After 10 years on this committee I am going to ask you my last question on interest rates. You often refer to interest rates being neutral. Where do we stand right now in relation to interest rates being neutral? On which side of neutral are we on?

Mr Macfarlane—The best I can come up with is that there is a band called 'neutral' and we are probably near the top of the neutral band, but you could not really make a case that they are restrictive or contractionary yet. I think when I was first asked this question I said that the real interest rate that had prevailed over the low-inflation period was about three per cent. If we were at 2½ per cent inflation, which is the average that you would hope that in the very long run you would come out at, that would give you a neutral rate of about 5½, plus or minus half a per cent for rounding error. So 5½ to six would be the neutral rate. We have an underlying inflation rate now of about three. Three plus three is six. We are either at neutral or at the top end of the neutral band.

Mr KEENAN—Governor, can we return to the cost of housing. You mentioned, I think quite rightly, that it is a demand and a supply problem. One thing you did not mention—and I solicit your comments on this—is that it also has to do with planning. I think state governments are trying to steer people away from the idea of larger blocks and houses, but Australian people are not showing a lot of desire to do that. Instead, they are just paying more and more to have a house on a large block of land. How significant are these planning policies in housing affordability?

Mr Macfarlane—I did mention them, but I mentioned them using the term 'land release'. I think the supply of land or the rate at which land is released does have an impact. There has been a lot of discussion recently, and a lot of economists have been looking at this issue. At one extreme there are people who say, 'We shouldn't release much land because it's too expensive to service it out there and it's urban sprawl; that's a bad thing,' so they tend to want to have urban consolidation rather than a lot of land released at the periphery. On the other hand you have people who say: 'Look, if you really want cheap housing, go to Atlanta or Phoenix or to these US cities where they have no planning. Sure, they have urban sprawl, but they also have cheap houses. It's much easier for people in those places to buy their first home.'

These are the two extremes, and you have to find a happy medium between the two. I am not sure exactly where that happy medium is, but I think you have to recognise that there is a continuum, and you want to decide which part of the continuum you want to be on. There is a cost to being at either extreme. I think there is a lot of very spirited and interesting debate going on about that at the moment in Australia.

Mr KEENAN—This question is on another topic altogether: the Japanese economy. We spend so much time talking about China. There have been some false starts in the Japanese economy before. Do you think that now it is sustainable and they have returned to modest levels of growth and that will continue? If so, how significant do you think that is for the Australian economy?

Mr Macfarlane—I think the answer is yes. They have got over their series of false starts, which went on for more than a decade. I think they are growing reasonably well now. You cannot expect them to grow extremely rapidly, though, because their population is basically stable. It is not growing. So, even when they do return to good growth, it is not going to be really rapid growth. But it will be important for Australia, because they are still an extremely important customer for Australia. That is one of the many things which make me reasonably confident that world growth will continue. I think the big thing about them that has really changed is that their banking system has finally returned to health. One of the ways they did it was to reduce the number of banks from 21—or was it 14?—to three, basically. Anyhow, there has been this consolidation of their banking sector. The banks are now, after—it must be—a decade, finally increasing their lending. They were reducing their lending for a full decade.

Dr EMERSON—This question is about the exchange rate—not about forecasts on the exchange rate but about how mechanistically the Reserve Bank deals with movements in the exchange rate and their implications for Australia and for inflation. The question is to the deputy governor. We know the interest rate spread between the United States and Australia is narrowing and there is at some stage the likelihood of mineral prices moderating. Those two factors could lead to a depreciation of the Australian dollar. Recently the prices of non-traded goods in the Australian economy have risen faster than the Reserve Bank's target range, but that has been offset by slower growth in the prices of imported goods, partly due to the appreciation of the dollar and partly due to the fact that we have very cheap Chinese imports of manufactured goods in particular.

If the dollar did depreciate, would that remove the cushion on the domestic price inflation, remove that offset? And this is the mechanistic question: does the Reserve Bank take account of that change in price movements—that is, that if the dollar did fall the prices of imports would in fact start to rise? Does the Reserve Bank take account of that in its assessment of the inflationary outlook and of underlying inflation? I am not asking you to predict the direction of the exchange rate; I am just asking how the Reserve Bank deals with these issues.

Mr Stevens—There are two levels on which I think I will try to answer that. One is the mechanical level. In forming a forecast, we make an assumption about the exchange rate, which is typically that what we observe today will persist. We know that will almost certainly be wrong, but what we also know is that, if there is one variable that the economics profession cannot forecast very well at all, this is the one. So it makes no sense, really, to form an elaborate forecast, so we make a technical assumption that the exchange rate will be where it is and then we go through the forecasting process from there.

If the exchange rate we happen to observe when we make that forecast has come down a lot from the last time, then that will add to the amount of inflation in the forecast, all other things being equal. Bear in mind that, typically, all other things will not be equal because the exchange will have moved for some reason, and it is usually important to know why it moved because that conditions what it means for the economy.

In the circumstance or the hypothetical situation that you outlined, what has happened there is that the world economy has weakened, the commodity prices have come down and our terms of trade have declined, so that is a contractionary event for this economy. So in that world the exchange rate decline would presumably be a bit less inflationary than it would be if it just went down for some other reason, perhaps. That is the mechanical answer. That is how we form our forecast, and I think one cannot really do it any other way.

Then there is the question of how the policymakers think about that forecast when they make a decision every month on interest rates. Observing a temporary rise in the inflation rate because the exchange rate has declined, do they immediately mechanically rush out and tighten policy? Not necessarily, because it may be that this is just a temporary thing, it will pass and in a year's time or two years time we will be back to inflation rates that are fine.

You might elect to leave interest rates alone, or you might feel that, in this hypothetical world, there is a risk of temporarily higher inflation feeding back to other prices, wages and inflation expectations, then giving you a more persistent problem. If you thought that was the risk then you would have to respond to that. So it depends a bit on the circumstances, but I think the key point is we are trying to form a judgement on where the medium-term inflation trend will be, and we do not necessarily have to respond in a mechanical fashion to a temporary deviation—similar, say, to oil prices.

Ms GRIERSON—Given the comments on the payment systems and this committee's work and its recommendations which would see online functionality given to EFTPOS cards, to saving cards, and given all the young people here, would you encourage them and their parents to be lobbying financial institutions to introduce that functionality so that they can book concerts and buy things on the net without having to access their parents' credit cards?

Mr Macfarlane—What is referred to as 'online EFTPOS' does not necessarily involve an EFTPOS card. You go to a website that is selling something, you order what you want to buy, then the website asks you how you are going to pay and you say you are going to pay from an internet account. That website switches you over into your own bank account and transfers the information about the sale into your own bank account. It debits the amount from your bank account and that is paid to the supplier. It is a marvellous system and it is certainly much superior to using a credit card. It is much more secure and it is also much cheaper for the merchant. We would certainly be very much in favour of the development of that system, which is referred to as online EFTPOS but is not really because you do not have to have an EFTPOS card. What you do have to have is a bank account with internet access. Also, the merchants that are selling over the internet must sign up to this system so they can switch you from their site to your own site. We are certainly very much in favour of that. I agree with you that it will be beneficial for a lot of people, and that definitely includes parents whose credit cards are currently being used.

CHAIR—Talking about students, we have been lobbied to have a couple more students' questions. First is Max Hardy of Caringbah High School, which is of course the school which the deputy governor's daughter attends.

Max Hardy—Firstly I would just like to congratulate Mr Macfarlane on his tenure. At the risk of sounding like a sycophant, I will get on with the question. Governor Macfarlane, given the time lag of monetary policy of 12 to 18 months, have the interact impacts already been felt by the 0.25 per cent interest rate increases this year? Should the RBA tread carefully with future increases to ensure that the economy will not swing into a significant downturn?

Mr Macfarlane—That is a good question. You are quite correct, the effects of monetary policy are felt with a lag. This is why you have to constantly be adjusting monetary policy to what is happening in the economy and making a forecast of what is likely to happen. It would be a big mistake to continue, for example, just raising interest rates until you saw a clear sign that some sort of downturn was occurring. That would almost certainly mean that you had gone too far. You have to stop long before the clear physical evidence has arisen.

CHAIR—The next question is from Carlo Macri from Fort Street High.

Carlo Macri—To what extent do you attribute inflation targeting and other factors to Australia's elongated business cycle? Do you see a global trend to more sustainable and longer business cycles in the future?

Mr Macfarlane—I think the fact that we now have a much better monetary policy framework, the framework of inflation targeting and an independent central bank, has been an important factor behind the long expansion. It has not been the only factor but it has been a very important factor. The increased flexibility of the economy has also been important, and I think the fact that the global economy has been less tumultuous than in previous decades has also helped. Not that we have not had some local shocks—we had the Asian crisis, which was a significant shock—but I think the framework has greatly improved our ability to run a stable economy.

Your second question could be boiled down to: is the business cycle dead? Have we now entered a world where there will not be ups and downs and booms and busts and recessions? I do not think so. I do not think we have entered that world; I do not think we will ever enter the world. I think we have entered a world which is a bit more stable than it has been in the past, but I do not think we can ever assume that these things will not happen again. In fact, I have been saying this for a long time. This was said, by the way, in about 1970. There was a burst of optimism in economics where a number of books were published with titles like *Is the business cycle dead?* We know that within a couple of years the world had a severe recession. It was not dead; I do not think it is dead now, although I think it is not as pronounced as it used to be. It should be slightly easier to manage economies than in previous decades.

CHAIR—The final question for today is from Despina Roussakis from East Hills Girls Technology High School.

Despina Roussakis—One topic frequently discussed throughout our course has been the Australian exchange rate. What factors does the Reserve Bank take into account when intervening in the exchange rate, and how do you weight those factors in accordance with economic management objectives?

Mr Macfarlane—We have a floating exchange rate regime, which is the best regime Australia could have, and it is certainly the best we have had. That does not mean you are totally uninterested in the value of your exchange rate. Some people think that if you have a floating exchange rate, you do not care what happens to it—you still do. I think as time has gone by, the capacity for the economy to adjust through the floating exchange rate has improved. One of the biggest pieces of evidence for that is the pass-through into inflation of a given fall in the exchange rate has become smaller and smaller as time has gone by. One of the potential risks of a floating exchange rate has been reduced. So we are probably more comfortable now with our floating exchange rate than we were in the first 10 years after it was introduced.

CHAIR—Thank you very much for the input from the schools and the quality of the questions asked. I congratulate you. Governor, we have come to the end of the session and it is appropriate that we should recognise that, after 10 very successful years, this is the last opportunity the economics committee have got to ask you questions relating to the performance of the Australian economy and your plans to manage inflation. I want to say it is the unanimous view of the committee that you have done an outstanding job in your role as the guardian of the Australian economy. We thank you for being one of the principal architects of the success that we have seen, this longstanding economic boom Australia has experienced without the downturn that other countries have seen. I was with a leading economist yesterday, an American economist, who said that we are in fact a global model for what could be done with an economy. So, for your part in that, we thank you and recognise your great achievements.

You mentioned that you see that the role of the Reserve Bank is to do with inflation, and you have clearly been very successful in containing inflation; with the welfare of the Australian people, and there is no doubt that all Australians are better off under your tenure and we have seen an average of 16 per cent growth in wages across the board; and with employment, and we have just reached a 30-year low, at 4.8 per cent, in unemployment levels. So, by any criteria, you have had a very successful tenure. We thank you for your contribution to Australia and the Australian economy. On behalf of the committee I would like to thank you, and I ask Dr Emerson to join me.

Dr EMERSON—Thank you, Governor, for 10 years of great service to our country. I also want to acknowledge your role as a deputy governor. You did not to descend from the sky to become the Governor of the Reserve Bank. You, like other colleagues, have had a long history in the Reserve Bank, a fine and indispensable institution for our country. You served Australia well during that period and before. You presided over and had a big role to play in the relative price stability that this country has enjoyed and that built on the economic reform programs initiated in the 1980s and carried on after that, which has allowed for a sustained—in fact, a record—period of economic growth, now stretching to 16 years. May it long continue.

Over the last 10 years, Governor, you have adjusted monetary policy in a very timely fashion. I think we should observe that that has not been the case with other central bankers around the world, which, if I could say, makes you the Yogi Bear of central banking: you are smarter than the average bear and you have not made any boo-boos—so congratulations. I hope you enjoy a quieter life and you are not so vigorously interrogated in your next incarnation. I thank you very much on behalf of the Australian Labor Party for the contribution that you have made.

CHAIR—I would like to say one last thing. On a recent visit to the United States the head of one of the major banks that I met with said that he regarded Governor Macfarlane as one of the four best governors of reserve banks in the world. That was some plaudit, said in New York on an independent basis. I think it is appropriate that the last word should go to the one member of the committee who has been on this committee for the whole length of the time you have been governor, and that is Alex Somlyay.

Mr SOMLYAY—I would like to endorse what both Bruce and Craig have said. To me it has been an absolute pleasure to have been on the committee during the whole of your tenure as Reserve Bank governor. You have dealt very diplomatically and patiently with a number of very parochial MPs from both sides, the government and the opposition. You have never dodged a difficult question. You have always given full and frank responses to every question. We may not have always heard what we wanted to hear but we always knew that those answers were to the point and professional. You will realise that you have finally left this job when one day you walk into a shop to do your shopping, take out your wallet, look at the banknote and see Glenn Stevens's signature on it instead of Ian Macfarlane's. We wish you the best in your retirement, Mr Macfarlane, and thank you.

Mr Macfarlane—I want to respond very briefly by saying I thank you very much for the kind remarks you have made. But they have been misdirected; they should go to the Reserve Bank as an institution rather than to the head of the Reserve Bank. The depth of ability, dedication and professionalism in the Reserve Bank is enormously impressive. I am sometimes overawed by it. I think one of my wisest decisions was to get out now because I am on a downward trend and my colleagues are still on an upward trend. I think you will discover that my absence will make very little, if any, difference to the quality of the work that is done by the Reserve Bank. It will continue to be of a very high standard and I am sure will continue to improve. Thank you very much.

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 1.00 pm