Mr Chairman, members of the Committee.

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

It is fitting that this hearing take place in Western Australia, where the effects of some of the profound international forces affecting the economy are perhaps clearest. I refer of course to the rise in the relative price of natural resources, which has increased shareholders’ and employees’ incomes in the resources sector, increased the flow of labour and capital into that sector, and had a flow-on effect on a range of other industries. This has all fostered a generally very expansionary set of conditions in Western Australia in particular, though the effects have spread around the country.

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

Nonetheless, the rise in Australia’s terms of trade of over 30 per cent over the past three years, taking them to their highest level for 50 years, is expansionary overall. The real incomes of Australians are higher and, other things equal, this adds to demand. For macroeconomic policy, it is a matter of ensuring that the economy adjusts to the change as smoothly as possible.

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

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

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

Approaching full employment is, of course, something to be welcomed. It is a goal of macroeconomic policy. If full employment is a ‘problem’, it is the one you would rather have than the problem of chronic unemployment. When we do not have full employment, it is appropriate – inflation considerations permitting – for growth in demand to be faster than normal in order to use the unemployed reserves of labour and capital. In the recovery from a business cycle downturn, that is typically what macroeconomic policies seek to achieve.

But by the same token, once full employment is more or less achieved, the pace of expansion in aggregate demand that was earlier desirable will now be too fast. It has to slow a bit, to be more in line with the rate of growth of the economy’s productive capacity. Otherwise, we would face the problems of overheating, inflation and eventually another downturn. It is that adjustment to more moderate outcomes for spending and output growth which we have been seeking in Australia in recent years.

That this is necessary is confirmed by the fact that inflation has picked up somewhat. CPI inflation in 2003 was 2.4 per cent. In 2004 it was 2.6 per cent, and in 2005 2.8 per cent. In mid 2006 it was nearly 4 per cent.

To be sure, the consumer price index was affected by the rise in oil prices, and most spectacularly, the effects of Cyclone Larry on the Queensland banana crop during March of last year. But the rise in prices was more widespread than just those items. Measures of underlying inflation, less influenced by specific price shocks, suggested a pick-up, albeit a much more modest one, from about 2½ per cent to about 3 per cent by mid 2006.

A short-lived pick-up of that magnitude is not necessarily a major problem in itself. But in an economy with limited spare capacity, continuing signs of quite solid growth in demand, and
experiencing a substantial external stimulus, that gradual trend rise in underlying inflation was worrisome. A continuation of this trend could have seen inflation exceeding the 2–3 per cent target over a more sustained period, even after temporary factors had disappeared. It was this risk – not banana prices or petrol prices per se – to which monetary policy had to respond. It was intended that the rise in interest rates, by restraining the growth of demand, would allow the supply side of the economy some time to catch up, and so act to contain inflationary pressures over time.

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

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

Looking abroad, the world economy continues to post a strong performance, led by the US and China. Many commentators have for some time pointed to the possibility of a sharper-than-expected slowdown in the US economy, due most likely to a weakening housing sector pulling down activity elsewhere, as a key downside risk. To date that risk does not seem to have materialised, and recent data suggest growth has been close to trend for the US economy, even with a weak housing sector. At the same time, recent inflation outcomes in the US show some moderation. There is little sign that China’s rapid expansion will end any time soon and recent growth in the euro area has recently been the strongest this decade. So, while forecasts made by the IMF and other institutions for the world economy have for some years been qualified by statements about downside risks, it appears that current trends are, once again, at least as strong as the forecasts.

While prices for some commodities have retreated from their peaks, others have remained very high. The prevailing levels of prices will, in all likelihood, continue to prompt high levels of investment in the resources sector both in Australia and abroad. No doubt the resulting expansion in supply will, in due course, dampen prices for commodities to some extent. Even so, it appears likely that Australia’s terms of trade will be higher on average over the years ahead than they were through the 1980s and 1990s.

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

To some extent, these trends in financial pricing may well reflect a genuine decline in some dimensions of underlying risk. Variability in economic activity, and in inflation and interest rates, has clearly diminished over the past 15 years in a number of countries, including Australia.
The associated prolonged period of attractive, steady returns on equity investment and low cost of long-term debt funding certainly seems to have set the stage for a return to somewhat higher leverage in the corporate sector. This is most prominent in the rise in merger and acquisition activity and the re-emergence of leveraged buyouts around the world. Corporate leverage had been unusually low after the excesses of the 1980s, so some increase is probably manageable. Nonetheless, after more than a decade in which the main action in many countries has been in household balance sheets, this trend in corporate leverage will bear watching. For the time being, at any rate, financial conditions are providing ample support for both corporate investment and household spending around the world.

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

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

All of this should mean that domestic demand will rise at, or slightly below, trend pace over the coming year. With some export sectors expanding as additional capacity comes on line, our central forecast is for growth in non-farm GDP to pick up to about trend during the next couple of years. Total GDP growth will be lower in the near term because of the drought’s effect on the farm sector. If rainfall patterns improve in the months ahead, there would presumably be some recovery in farm production during 2007/08, though the likelihood of that, let alone its strength, is inevitably highly uncertain at this stage.

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

At our most recent meeting two weeks ago, we felt we could be a little more confident in that inflation forecast. We will, of course, see some large movements in CPI inflation in the next few quarters. It will probably fall noticeably below 2 per cent on an annual basis, as falling petrol and banana prices have their effect. After that, it will rise again, as those temporary factors fade, and we currently expect that CPI inflation will be around 2½ per cent by early 2008, remaining around that rate thereafter. That is, it appears likely to be lower than recent outcomes, but closer to the top than the bottom of the 2–3 per cent target range.

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

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

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

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

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

The review will be an open process, which will include a conference towards the end of this year bringing together policy-makers, specialist academics and industry practitioners. We plan to release our preliminary conclusions in the first part of 2008 and then we would again consult widely before making any changes to the current arrangements. We expect the review to be completed in late 2008. This is a lengthy process, but it has to be if the discussion is to be based on the facts, everyone with something to say heard, their views considered carefully and the Payments System Board to undertake proper deliberation.

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

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