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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Government economic stimulus initiatives

MONDAY, 28 SEPTEMBER 2009

SYDNEY

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**SENATE ECONOMICS
REFERENCES COMMITTEE
Monday, 28 September 2009**

Members: Senator Eggleston (*Chair*), Senator Hurley (*Deputy Chair*), Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Bob Brown, Cameron, Coonan, Eggleston, Fielding, Hurley, Joyce, Ryan and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

The economic stimulus initiatives announced by the Government since October 2008.

The Senate requests the committee:

- (a) to invite the Secretary of the Treasury, accompanied by any other officials he considers appropriate, to appear before the committee, on or after the morning of Monday, 14 September 2009, for the purpose of giving evidence on the matter;
- (b) to invite the Reserve Bank Governor, Mr Glenn Stevens, and other independent pre-eminent economists to appear before the committee, on a date to be determined by the committee, for the purpose of giving evidence on the matter; and
- (c) to hold public meetings to take evidence from those witnesses, in the form of a full update on the economic stimulus initiatives, which addresses:
 - (i) the efficacy of the spending measures to date,
 - (ii) the anticipated costs and benefits of continuing the spending measures,
 - (iii) consequent change in the stimulus 'roll out' that ought to be entertained given the changed economic circumstances,
 - (iv) anticipated impact of the stimulus spending on future interest rate movements and taxpayer liabilities,
 - (v) an evaluation of the environmental impacts of the spending to date, and
 - (vi) other related matters.

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Committee met at 9.14 am**STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia**

CHAIR (Senator Eggleston)—I declare open this second public hearing of the Senate Economics References Committee inquiry into the government's economic stimulus initiatives. At last Monday's hearing in Canberra, we primarily heard from academic economists. Today's witnesses will include the Governor of the Reserve Bank and representatives of the business community.

These are public proceedings, although the committee may agree to a request to hear evidence in camera or may determine that certain evidence should be heard in camera. I remind the witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a Senate committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to the committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time.

I now welcome the Governor of the Reserve Bank, Mr Glenn Stevens.

Senator BOB BROWN—Chair, I just have a question for you, if the governor does not mind.

CHAIR—Is it about procedure?

Senator BOB BROWN—I note in the *Financial Review* that the Secretary to the Treasury has withdrawn from today's hearings, and as a participating member I am not aware of the circumstances of that. For the public record, I wondered if you could inform us why that has happened.

CHAIR—Yes, I am prepared to do that. Unfortunately, the Secretary to the Treasury was unable to reply to a set of questions which the committee sent to him in sufficient time, in the opinion of the committee, for the committee to consider the answers and then proceed to the hearing today, so it has been agreed that the Treasury will have until next Friday, 2 October to prepare answers to those questions and that Dr Henry will appear before the committee on 9 October in Canberra to deal with these issues.

Senator BOB BROWN—And are those questions available, Chair?

CHAIR—Yes, they are, Senator Brown. I am sure the committee secretary can provide you with a copy.

Senator BOB BROWN—Do we know when Treasury were given those questions?

CHAIR—They were posted to the Treasury and they appear to have arrived rather late, and so the Treasury were unable to prepare answers to them because they are at this time concerned with preparing the final analysis of the outcome of the budget.

Senator BOB BROWN—Finally, could those questions not have been answered if the Treasury secretary had appeared this afternoon?

CHAIR—The answer to that is yes, he could have answered them orally, but it was felt by members of the committee at a private meeting held last Friday that the members of the committee needed time to work their way through the questions and answers, and consider their responses to them.

Senator BOB BROWN—Even though the oral answers would have been available this afternoon?

CHAIR—Oral answers tend to be fairly short, and the committee was looking for fairly comprehensive answers to the questions which they sent to the Treasury.

Senator BOB BROWN—And they felt they could not tease out those comprehensive answers this afternoon?

CHAIR—As I said, answers to questions in hearings tend to be fairly short. This committee was looking for fairly comprehensive answers upon which to base questions to the Secretary to the Treasury—and that was a committee decision, Senator Brown.

Senator BOB BROWN—Right. I just want to have it recorded that this was the first I knew about it.

CHAIR—Well, as you said, you are a participating member rather than a full member of the committee. But we did put out a press release on Friday afternoon advising the media that Dr Henry's appearance would be on the 9th. But I think we should proceed, because time is short.

Senator CAMERON—You keep indicating that this was a committee decision. It was a majority committee decision by the Liberal and National members of the committee. The Labor members opposed it. We felt it would have been appropriate for the Secretary of the Treasury to be here this afternoon. I just want to make it clear it was not a unanimous committee decision and that impression might have been given.

CHAIR—Thank you. We like our senators to be fully and properly informed, though, before proceeding to inquiries. Mr Stevens, would you like to make an opening statement?

Mr Stevens—Thank you. I have some opening remarks that I can offer that perhaps will help frame the discussion, and they are mainly about the economic situation. Economic conditions in Australia were, as you know, generally quite subdued in the second half of 2008 and the first part of 2009. Output was sluggish, hours worked in the economy declined, unemployment rose and inflation started to abate. By the standards of past recessions, however, this was a mild downturn. The evidence is as yet incomplete, but this episode has been much less serious than those in the mid-1970s, the early eighties or the early nineties. It has also been very mild indeed

in comparison with the outcomes recently in other countries where deep recessions have been experienced. If we take the G7 group of advanced countries as an example, there was a contraction in real GDP of nearly five per cent over the four quarters to June this year for that group of countries. The Australian economy recorded a small net expansion in GDP over that interval. I think it is reasonable to conclude against the benchmarks of historical experience of our own and in comparison with experiences abroad that Australia has done quite well on this occasion.

The question is: why was that so? The key factors have been articulated before by me and also by many others, but it may help to frame the discussion if I recount those. Firstly, our financial system was in better shape to begin with, being relatively free of the serious problems that the British, the Americans and the Europeans experienced. Lenders have some problem loans as they always do during a downturn, but these are manageable. Our banking system has continued to earn a positive return on its capital, unlike those in a number of other countries. The system has been affected by spillovers from the global crisis through tighter borrowing conditions in international markets, higher spreads and so on, but those too have been manageable and various policy responses have helped the system to cope. The Reserve Bank, for example, was prepared to expand its balance sheet when needed to help ensure liquidity and the various government guarantees were important in shoring up confidence and maintaining access to wholesale funding.

Secondly, some key trading partners for Australia have proven to be relatively resilient in this episode. The Chinese economy did slow sharply in the second half of 2008 but quickly resumed very strong growth. China will easily achieve their eight per cent growth target for 2009, led by domestic demand. Many of our other Asian trading partners also have returned to growth recently. Ongoing strength and demand for resources has kept Australia's exports growing and our terms of trade, even though well off their peak, remain quite high by historical standards. Confidence about the future in the resource sector is building in fact quite strongly.

Finally, Australia had ample scope for macroeconomic policy action to support demand as global economic conditions rapidly deteriorated, and that scope was used. The Commonwealth budget was in surplus and there was no debt, which meant that expansionary fiscal measures could be afforded. In addition, monetary policy could be eased significantly without taking interest rates to zero or engaging in the highly unconventional policies that have been needed in a number of other countries. I have maintained throughout that Australia's medium-term prospects remain good and that we should not lose confidence. More people seem to be taking that view now.

Measures of business and household confidence have shown a very substantial pick-up from the low points reached earlier in the year. Share prices have risen by almost half. House prices have risen rather than fallen, though commercial property prices have fallen. People are realising, I think, that, though things have been tough, the worst has not occurred and the future is looking brighter. Earlier plans for drastic cuts to business investment spending seem to be being reconsidered. Economic growth forecasts are being revised up.

A straightforward reading of the economic outcomes would, I think, suggest that the various policy measures have been effective in supporting demand. In due course both fiscal and monetary support will need to be unwound as private demand increases. In the case of the fiscal

measures, this was built into their design. The peak effect of those measures on the rate of growth of demand has probably already passed. The extent of support will tend to tail off further over the next year or so. In the case of monetary policy, the bank has already signalled that interest rates can be expected at some point to move off their current unusually low levels as recovery proceeds.

These adjustments back towards more normal settings for both types of macroeconomic policy are what should be expected during the recovery phase of a business cycle. Our most recently released set of forecasts—the ones released in August—assume that that occurs. Such an outcome would mean that fiscal and monetary policy would be acting broadly consistently, as they did when they were moved in the expansionary direction when the economy was slowing. In both cases a degree of policy discipline will, of course, be needed. This is where policy frameworks are so important—the frameworks are the key to enforcing that discipline.

On the fiscal side, the forward estimates provide an indication of the restraint needed to move the budget back towards balance and eventual surplus over time as required by the government's medium-term fiscal commitment. On the monetary side, the inflation targeting framework that the Reserve Bank has been following for a decade and a half will guide adjustments to interest rates. These will be timely and ahead of a build-up of imbalances that would occur if interest rates were kept low for too long. These frameworks will, in other words, prompt the needed adjustments.

It was the preparedness to take those adjustments in the past, guided by those very frameworks, that contained the build-up of imbalances in the upswing and which in turn earned us the scope to take bold measures to support demand when a recession loomed. A continuation of that approach into the future will, I think, serve us well.

CHAIR—Thank you, Mr Stevens. We have nine senators here, including Senator Joyce on the phone, and we do have an hour and a half for this segment so we will try to give everybody adequate time. As the chair, I will take the prerogative of asking you the first question. You mentioned the revival of China and the strengthening of the Asian economies in terms of maintaining our balance of payments and assisting our economy. Could you comment on what might have been the outcome and our present situation if that Chinese revival had not occurred—and to what degree is our present economic situation related to the fact that the Chinese economy provided support to our economy?

Mr Stevens—China slowed quite abruptly in the period from about August or September through to the end of last year. I think many people were surprised to find out that China's industrial production actually contracted briefly in that period, having been growing at 15 per cent or so leading up to that. That was associated with quite a sharp slowing in demand for resources and a big fall in commodity prices. We saw all of that unfold more or less coincidentally with the financial turmoil through the last few months of last year. The Chinese authorities of course, along with those in many countries, took some expansionary steps in response to that; and I think they have been very effective in returning that economy to growth.

China's natural tendency will be to grow anyway for various reasons that I am sure we are all familiar with. But those policy measures certainly turned that growth back on pretty smartly. Had that not occurred, and we are speculating now of course, many other things might also have

happened in response. But I think it is pretty clear that, in terms of export volumes, Australia stands out amongst our developed country peer group as having had pretty good performance—and by pretty good I mean that those export volumes are flat to up slightly over the last year; in contrast to declines in exports across a range of countries that range anywhere from 10 to 35 per cent depending on what products the country was involved in. So I think that has certainly been helpful.

The ongoing structural strength of demand for resources in China, and not just in China but also through the emerging world in general, is not really a cyclical phenomenon; it is a structural thing which I think is likely to persist for some time. It has been building over some years and there is a cycle around that structural trend, which we have seen. But I think that trend is a pretty strong one that is solidly in place. That is the thing which is basically responsible for the fact that the terms of trade, though down 20-plus per cent from the peak, are still, in comparison to a 20-year average, 45 per cent higher.

I think all of that is related to the story of the Chinese emergence, as well as countries like India and some others in the emerging world, so those things make a difference. They have been affecting our economy over several years now and they will continue to do so—I would expect for quite some years into the future. That is a structural phenomenon around which we have got these cyclical fluctuations. I think we as a nation would be materially the poorer had that not been occurring, of course.

CHAIR—So, in effect, you are saying that but for the Chinese recovery our economic situation might have been a lot worse today than it actually is?

Mr Stevens—I think it would be measurably weaker on resource export volumes, but then of course that is a very partial answer to the question. The full answer would be that other things would start to change—for example, the exchange rate would have been lower probably and so on. So by the time you allow for all those effects you start getting multiple impacts on the economy which we cannot work through in our heads, obviously.

CHAIR—Nevertheless, the Chinese recovery has been a key factor in the current position of the Australian economy.

Mr Stevens—It is one of the key factors. There is no question that our export volume performance stands out compared with many other countries, and China is a major reason for that. It is not the only reason that the economy has been pretty resilient, but it is certainly one of the key ones, as I said.

CHAIR—So on top of the measures taken by the government the China factor is a very important issue in terms of our present economic strength.

Mr Stevens—It is one of the important issues, absolutely.

CHAIR—Thank you. Since Senator Brown is the senator who referred this matter to this committee, we will go to him.

Senator BOB BROWN—Mr Stevens, has the government's \$42 billion stimulus package been a success?

Mr Stevens—The question is: what criteria would we use to establish the answer to that?

Senator BOB BROWN—Yes, precisely. I would be very pleased if you could say what criteria you would use to establish that.

Mr Stevens—If the intention was to support demand in the economy in a period in which we had a very serious global downturn and which all the indications were that that was going to affect Australia significantly, and if the intention is to provide some temporary support to demand in such a period, my conclusion would be that those measures have supported demand quite materially over the last—it is now September—probably nine or 10 months.

Senator BOB BROWN—This is one of those 'if only we knew' questions, but in regard to the stimulus packages generally used worldwide, how would you gauge or what would you say about their efficacy in avoiding the potentially disastrous situation we were looking at at the start of this year or late last year?

Mr Stevens—In other countries you mean?

Senator BOB BROWN—I mean worldwide. We were talking about a depression that may have been equal to that of the thirties. We have gone nowhere near that worldwide, let alone in this country. It has been argued that stimulus into the US economy, the European economy, China and, of course, Australia has been a difference—fast action, in other words, by governments is different to 1929-30. Is that so?

Mr Stevens—I think to have been prepared to move policy in an expansionary direction, given that threat, that is certainly better than an adherence to the idea that the budget must always be balanced, which was a view that some people certainly had in the 1930s. I think the reasons that the world has, if you like, sort of teetered on the precipice but has not got over extend a fair bit more broadly than just the fiscal measures. The fiscal measures are part of the story, but another big part of the story was that, faced with very serious strains in financial systems, governments and central banks did what was needed to stabilise that rather than letting it keel over. I think we would have had a much, much worse outcome globally had those measures not been able to put a floor under the banking systems of the US, the UK and a number of European countries. I think that has been very important, and, of course, central banks eased monetary policy very aggressively. Interest rates are at zero in a whole lot of countries. That also matters. So I would not say myself that the fiscal measures per se were necessarily the only reason that we did not end up with a repeat of the 1930s. There are a whole lot of things in operation. Of course, we do not know for sure whether we would have repeated the 1930s anyway, but on the assumption that that was the threat, which I think was a reasonable assumption, a lot of strong measures were taken across a range of fronts and they have all contributed.

Senator BOB BROWN—Governor, if we take the stimulus measures domestically and internationally away, do you think the result would have been different?

Mr Stevens—It would have been weaker, yes. I do not have any doubt that that is true.

Senator BOB BROWN—Do you think we would have faced a recession and/or depression in this country had these stimulus packages not been there?

Mr Stevens—I do not think we would have faced ‘the Great Depression’. For the reasons I set out in my opening remarks—the root problem here of financial excesses, too much leverage, too much risk taken, housing market collapses et cetera that you have seen in these other countries—we did not really have that problem. We would have been affected. We would have had recession. I am not sure we would have had depression—personally I would not have thought that—but we certainly would have faced a deeper downturn than we have ended up having. And that is costly, of course.

Senator BOB BROWN—I guess the committee’s central question is: ought the stimulus be reined in now that things are looking better and, if so, in what way?

Mr Stevens—I think the important point here—and I am not an expert in the programs; it is not my area—is that, as the programs are designed, they have an effect for a period of time but they will wane if things proceed on the current track. So it is built in that the stimulus withdraws gradually over time. As I said earlier, it is likely that, as conventionally measured, the maximum effect on the rate of growth of demand was in the June quarter—so we are already passed that—and the increments are getting smaller after that. So your question really, with great respect, should not so much be, ‘Should it be wound in?’ because it is going to be automatically; it seems to me that thing you are really debating is: should that process be accelerated?

Senator BOB BROWN—That is right.

Mr Stevens—All I can say in response to that is that I think it is a bit hard to claim that as of this moment there is too much growth in the economy. I have not had a serious problem with what has occurred on the fiscal front thus far. The presumption we are making is that things will be delivered and then wound back more or less on the schedule that is set out in the budget. There is probably going to be a bit of slippage but, if it is only a few months, that is not really a big deal. So we are assuming that withdrawal occurs more or less on that schedule. I am not sure that I would say that that outlook is a terribly worrying outlook really. This has been a good episode for Australia. We have come through this well. We are in recovery now, I think. It is important that these measures be wound back over time, but they are on track to be so.

Senator BOB BROWN—So you would not advise a review of the infrastructure spending and the other components of the stimulus package at this stage?

Mr Stevens—It is not really my place to give advice on fiscal measures.

Senator BOB BROWN—We are here to seek what advice we can get about the tweaking of this stimulus package, because it will lead to a longer deficit, won’t it, if it keeps going as is?

Mr Stevens—If the various measures proceed as planned, I would hazard a guess that in five years time we will look back and find that the debt build-up was not quite as large as we originally forecast. I do not know that for sure, but that would be my guess. The debt ratio in that

world—unless something else goes wrong—might well peak a little bit lower than the government had in May. It is their call what they do with their projections, but my observation would be that the economy is performing a bit stronger than thought then—the recovery is going to be a bit earlier, which is good—and in due course that will help the budget through the natural growth of revenue. That probably will take a little while, but over time I would hazard a guess that we might be surprised that the debt build-up turns out to be not quite as large as earlier thought.

Senator BOB BROWN—Is that not an argument, however, for us to review the stimulus package with a view to spending less and taking the time to target it better?

Mr Stevens—It might or might not be. The process I am describing, I guess, is what economists would refer to as the natural automatic stabiliser properties of the tax and spending systems. So, if the economy speeds up, we will find that tax revenues will tend to grow a bit faster with that and some kind of spending—certain welfare benefits, for example—will tend to slow down. That does two things. That is the sort of natural repair process for the government's balance sheet and, as the name 'automatic stabiliser' implies, it actually tends to lean a little bit into the pace of expansion, which is a natural and welcome feature of the system. Does that mean that you should also consider changing the discretionary measures? That will be a separate question.

Senator BOB BROWN—What do you think on that?

Mr Stevens—It is not really my call.

Senator BOB BROWN—I am just seeking your advice.

Mr Stevens—I am not a fiscal adviser. I do monetary policy and I take fiscal policy as given—

CHAIR—I think we have to recognise the parameters within which Mr Stevens operates.

Senator BOB BROWN—I just have one other question on another matter. Do you think interest rates should be kept in check while unemployment is rising?

Mr Stevens—I think what interest rates should do is respond to the outlook for the economy and inflation in a timely fashion. Whether that turns out to mean that they start to rise before unemployment stops rising remains to be seen. I think it is fairly apparent, is it not, that unemployment is not going to reach the sorts of peak levels that all of us feared only a few months ago.

Senator BOB BROWN—But it is on the up.

Mr Stevens—Actually, it has not moved at all for four or five months. Whether that is the peak or not, we are not sure—we do not know. Only time will tell.

Senator BOB BROWN—But the hours worked are on the decrease.

Mr Stevens—I do not want to sound callous in the way I say this but I think if it peaks at six-point something that is a pretty low peak in comparison with others we have seen, and we should be glad if that occurs. At the same time—and I have not come today to try to steer expectations about interest rates; I am trying to avoid it, in fact—interest rates are unusually low. That means that we do have some work to do at some point to head back towards normal before we get a build-up of problems that we would get if we keep them really low for too long. Our job is to not only try to manage that path in a way that pays due regard to the unemployed and all that goes with that, of course, but also to try to make sure that we do not give ourselves some bigger problems down the road—which, if we had those, would be very detrimental to the unemployed.

Senator COONAN—Thank you very much, Mr Stevens, for appearing before the committee. I want to go to a slightly different aspect of this inquiry and discuss with you the trade-off between fiscal and monetary policy. The August statement on monetary policy indicated the importance of unwinding excessive monetary stimulus and adjusting rates back towards normal levels if the revised growth levels are borne out. I would like your views on whether that would need to be lessened or calibrated differently if fiscal policy was tighter. In particular, my question is: if there are potential imbalances in keeping interest rates low for too long, what are the dangers that you see in keeping fiscal policy too easy for too long?

Mr Stevens—It is true, as you say, that we signalled in the August statement and in our post-board statements that we anticipate that, in due course, it will be appropriate to go from what I have occasionally described as an emergency setting back towards something more normal over time. I do not think I would regard the stimulus we applied as excessive—which was, I think, the word you used—but it is certainly true that it is unusually big. I think that was appropriate given the balance of risks that we faced at the time. As the balance of risks changes, then of course we have to reconsider.

What are the dangers of keeping fiscal policy too expansionary for too long? I can, I suppose, think of two dimensions here. One is that, if we keep macroeconomic policy generally too expansionary for too long, at some stage we will start to grow faster than the economy can sustainably cope with and we will get inflation pressure. At the moment that is not on people's minds, for the most part, but down the track that will obviously be something that we will need to keep in mind. If we are talking about keeping the foot right down for a year or two too long, that obviously becomes a significant danger—whether it is fiscal or monetary. That is one set of dangers that is attendant to both of the macroeconomic policy areas at least in principle.

The other element in fiscal, of course, is the long-run sustainability of the government's balance sheet. I would have to say that I think the prospective debt that we are going to have—according to the budget outlook—for a country like Australia ought to be seen as quite manageable. We are talking about 14 per cent or 15 per cent of GDP for net debt, if it reaches that. That certainly is a significant change from where we started, but I would be pretty sure that most governments in the world would be very, very happy to have a picture like that ahead of them rather than the one they have actually got in their own country.

Obviously if you keep a budget deficit of five per cent of GDP for a long time, you are going to build up quite a bit of debt—and we certainly should not do that, and we will not do that if things evolve remotely like what is in prospect or what is outlined in the forward estimates. In the near term, I personally am not greatly worried by the debt sustainability angle here. I do not

think that is likely to be our problem. The more important issue will be for the joint support being given by both fiscal and monetary policy to be withdrawn in a timely fashion as the recovery proceeds—not too soon, because we do not want to abort the recovery but not too late either, because we do not want to overheat it.

Senator COONAN—On the exit strategy, as you quite rightly point out, it has an automatic phase-out—that is part of its design—but it is a drawn-out exit schedule. The measures will be pushing up the level of GDP until at least mid-2012. Is there not a risk that this big budget stimulus will become destabilising if it is not recalibrated as the emergency has passed, and won't that show up, for example, in asset bubbles, particularly in the housing market? I know the first home owners grant is due to wind down, but subsidies have been capitalised into the price of assets and it obviously boosts an expectation of further price rises. Isn't the real danger the potential asset bubbles?

Mr Stevens—The potential for asset price misalignments or bubbles is obviously something that we need to be wary of. I would say that the possibility of very low interest rates for a long period is the bigger contributor to likely imbalances. That is actually an argument, I think, for making sure that the return towards normal on monetary policy is not delayed. On fiscal, as you say, the first home grant is a potential contributor although that is waning. We already know that loan approvals to first home buyers are actually declining now—they have been for a couple of months—so we are probably through the worst danger period for that potential problem. On the fiscal stimulus issues I would not be looking for asset price issues and the problems that would arise there; they will come from monetary, not fiscal, if they come.

Senator COONAN—Unfortunately, we do not have very much time and I have a lot of questions. I am conscious that a lot of people want to ask questions. Just coming back to unemployment, has the bank done any modelling on the effect of current fiscal policy on unemployment?

Mr Stevens—We have not, as far as I know, asked for a specific exercise on how many jobs the various measures have contributed to. So, on that specific question: no, as far as I know, we have not done that exercise, but I think the way you do these things generally is to say, 'Approximately'—this is a bit rough but it will not be that far from the answer—'if you think a set of measures has boosted the GDP by X then it has boosted the level of employment by something around about X per cent.' You feed your figure in and get the answer.

Senator COONAN—So it is reasonably rough and ready but a good approximation.

Mr Stevens—If you were to believe, for example, that the sequence of measures boosted the level of GDP by, let's say for the sake of doing the sums, a percentage point—I will just pick that number; I am not saying that is the number—it is possible that the productivity of the people employed is different to the average, but leaving that aside, roughly speaking you would start with the idea that the level of employment would be a percentage point higher. There are 10 million jobs so that is 100,000 people.

Senator COONAN—I see.

Mr Stevens—But can someone tell you which people and where? No.

Senator COONAN—I understand. In your statement on monetary policy—I think it was in August—you cited five factors behind Australia's economic resilience. You repeated some of them, which were: the strong state of the financial system, the significant monetary stimulus from the reduced cash rate, the fiscal stimulus, the depreciation of the exchange rate in 2008, and China's strong economic recovery. You have discussed China. I am just interested to know, in terms of process—and could you give me the outcomes?—what work the bank has undertaken to quantify the contributions of these five factors that have made to Australia's better than expected performance. How do you weight them?

Mr Stevens—That is a good question. In truth the answer to your question is that it is very difficult to disentangle all of these things because they all compound on each other. One can go through at a high level of aggregation certain features of the economy we see—for example, the strength of exports, as I said earlier, is mainly the strength and resilience of a number of our trading partners in Asia, not least China but not only China.

Domestic demand has not been strong, I would have to say, but it is not as weak as it could have been or as it has been in other countries. That is where I think the payments to households, for example, were important and also the decline in debt-servicing costs for indebted households, which in the six months or so up until March was the biggest decline that we have seen in our modern history. It was quite a big change. Can we say how many dollars extra those people spent as a result of that? No, we cannot. What we can say is that, for people who were indebted, debt servicing went down by about five percentage points of aggregate household income. Some of that will have gone to just paying down the debt faster and some of it will have been taken as higher discretionary income to spend. Of course, people who are savers, who, after all, are the ones funding the mortgages, have lower income, and plenty of these people write to me to complain about interest rates being low. So that is an offsetting thing, and the net balance is still expansionary.

Senator COONAN—It is very difficult to be loved by everybody, Governor.

Mr Stevens—It is not possible, actually. It is all very complicated. Our assessment would be that the combination of fiscal and monetary measures has added very materially to where domestic demand is now, relative to where it could have been. I am talking about somewhere between two per cent and three per cent higher.

Senator COONAN—When you talked about the dangers of fiscal policy, as far as I heard—and you may correct me—you did not mention either interest rates or the tax burden. Would you care to comment?

Mr Stevens—On fiscal?

Senator COONAN—Yes.

Mr Stevens—As far as I know, no higher taxes are proposed at this point. The picture that is painted in the forward estimates is that spending restraint, combined with a recovery in the economy, will bring the deficit down. As I said earlier, that will take a certain degree of discipline, which is why the framework is important. By interest rates, I assume you mean the long-term rates that the government borrows at. I do not think that, at the moment, it is easy to

discern much impact here. The long range in Australia is between five and 5½ per cent, which is about normal. It has been around that, on average, for the last decade. For a country like Australia, what we are talking about in government long-run borrowing costs is that there is a global rate which, roughly speaking, is the US Treasury rate, and we will be paying above or below that, by a little margin, depending on our individual soundness.

If we find that government borrowing rates are a lot higher in the years ahead, I do not think it will be because of Australia's outcomes. It will be because there is a lot of government debt being issued around the world by countries that have really serious fiscal problems, like the Americans and the British, with double-digit deficits and 80 or 100 per cent GDP ratios for debt. That poses a potential problem for long-term rates. It has not happened. In fact, long rates are unusually low at the moment. But, prospectively, that is an issue to watch. We would be affected by that, but not through our doing. What we are going to be determining by our fiscal actions is the increment above or below that global rate on capital that we pay resulting from idiosyncratic things. I do not think that has moved a great deal at all of late.

Senator HURLEY—I would like to go back to the issue of demand. I am worried by calls to wind back the stimulus to a large extent because of private demand. You referred to fiscal and monetary support and how that will need to be unwound as private demand increases. Ken Henry from Treasury referred to that in a speech of 23 September this year. He said:

... private sector demand needs to gather momentum. A key risk to the timing and speed of a recovery in private demand is the near-term weakness in income growth.

Whenever I am out speaking to small business in particular they are still referring to a tightness and the ability to get credit and the conditions surrounding that credit. If we are talking about winding back any economic stimulus I am very concerned about that sector of the economy. You mentioned that private demand is not too bad, but I am wondering how robust you consider it.

Mr Stevens—Actually I thought I said it was overall weak but nothing like as weak as it would have been. It basically has not grown over the year to the middle of this year but without the various policy measures we have had I think it would have been considerably weaker. How resilient is it going to be? There are a few things to keep in mind here. One is that the payments to households—which clearly have done something to hold up retail demand—have finished. So now as we sit here we are in the phase where we are going to be looking for a reading on how resilient consumption remains in the absence of those. It probably will fall back a bit. On the other hand, one reason for cautious optimism is that because the labour market deterioration has not been as bad as most of us had feared, we have seen a reduction in the extent of caution that householders feel and that is quite apparent in surveys of sentiment, which suggests that things will hold up okay in the period ahead.

On business investment spending, what we are seeing, compared with six months ago when businesses were understandably thinking, 'This is going to be really bad; I've got to pull my horns in everywhere, including on my hiring, my outlays, my inventories, my debt,' is that we are now in a phase where people are saying, 'You know, it's tough but it's not as bad as we feared and maybe we can rethink some of the cutbacks we were planning.' I would be hopeful that as time goes by we will see a degree of resilience there.

It is of course at this point in time impossible to know for sure. That is actually the inherent difficulty in policy-making: you cannot know and you will never know until it is too late. So a judgement has got to be reached. I think that there are grounds of caution but, by the same token, I would say that things are proving more resilient than earlier thought and there are reasons to think that that may also continue. We have revised our forecasts up a bit. I am not sure that will be the last upward revision but I do not know yet. I think that things are improving, and that is happening in other countries too. It is a matter of judging as best we can how things will unfold in that respect.

Senator HURLEY—My rule of thumb is that in the magazines and newspapers there is still advice to households on how to save money, how to reduce their expenditure and how to make cheaper meals at home. So I think that although there is clearly, as you said, an increase in confidence, it is not yet a very strong confidence and if stimulus is withdrawn in an accelerated way that may cause another blip in confidence and we may find ourselves going backwards again.

Mr Stevens—I am not actually here to propose an accelerated withdrawal of stimulus. I am just here to give you my read on the economy as best I can. Yes, I see the magazine articles, but we see a lot of other things too which I think suggest that we have come through this episode better than we all feared, and I think that is going to see confidence in the future continue to build.

Senator HURLEY—Let us move again back to a wider perspective. The terms of trade have declined over the same period. How do you see that unfolding? Is that coming back now? Our chances of export, apart from the resource sector: are they in an improvement phase?

Mr Stevens—It varies a bit. Manufacturing exports have been declining as they have been for every country in the world because this episode has been one in which the demand for durable products has been hardest hit. That is why countries like Japan and Germany, in fact, have had the weakest economic performance amongst some of the major countries. The rural sector of course is largely driven by climate swings. Services have held up reasonably well, I would say, and resources are rising very strongly.

On pricing, there has been a little bit of a tailing off on some of the prices just in the past month or so, but overall the picture that we have, I think, is one where prices of most commodities fell sharply from a very high level in the middle of 2008 and quickly reached a floor and have tended, if anything, to drift up over the past six months. Relative to last year, there is a loss of income earnings that is coming through, which is the point Ken was referring to in the speech that you mentioned, and that is correct. But I would only add to that that in the broad sweep of this, if we take our terms of trade we were on a trend decline for 30 or 40 years after the early 1950s with an occasional spike, and certainly between the early 70s and about the year 2000, they had a trend fall. There is a long set of debates in economics about whether natural resource prices always fall relative to manufactured prices, and that was the backdrop to that. But since about 2000—in fact since about the time the dotcom mania reached its peak—I think that the trend was starting to turn.

So if you take our terms of trade from 1980 to 2000, the level we are at today—20 per cent of the peak but 45 per cent above that 20-year average—that is a very big change. That is eight or

nine per cent of GDP worth of additional income in the economy each year compared with what it would have been had the terms of trade stayed on that old track. That is very substantial, and I think we will see over the years ahead a continued trend towards that part of the economy getting bigger as the share of the total.

Senator HURLEY—That will relate to our ability to pay off any debt in the future, I presume, if that does continue.

Mr Stevens—Higher national income is obviously helpful for meeting obligations depending how we use that income of course, and we have to make sure that we use it carefully and not carelessly. I think that we should also keep in mind that the resource sector of the economy getting bigger means that another sector is going to be relatively getting smaller and that will bring adjustment issues as well, as it has in the past.

Senator HURLEY—Part of the stimulus package that will come in of course is the infrastructure area, which presumably will support that growing sector of the economy. Is this what you—

Mr Stevens—Yes. The minerals sector of course builds most of its own infrastructure, certainly in the west, and there are certain bits in the coal sector in the eastern states which are publicly determined and so, yes, those bits of infrastructure will support the shipment of higher volumes over the years ahead.

Senator HURLEY—Just talking about one of our major consumers of resources, China, which, as you said, was growing, my understanding is that they intend to go ahead with their planned stimulus package. Is there any suggestion that they might withdraw it and, if they do, what impact would that have on Australia?

Mr Stevens—They have implemented a very substantial fiscal package quite quickly, which is one reason behind China's fairly rapid return to growth. Are they planning to pull back? I do not know the answer to that. I think there are some signals that some of the Chinese officials are a little bit troubled by some of the lending that it is being done, but I am not aware of what their plans are on the fiscal side.

Senator JOYCE—Does the amount of Australian borrowing—government borrowing—force up the amount of interest rates and, if so, by how much?

Mr Stevens—I take it that we are talking about the rates that the government actually pays to borrow at—

Senator JOYCE—And also by reason of the government's involvement in the market. Between the state governments and the federal government they were in there now for hundreds of billions of dollars. How much effect is that having on interest rates in Australia or is it having any effect at all?

Mr Stevens—I do not think that it is having a significantly large effect on the rates that they are actually paying at their tenders. As I said earlier, the 10-year yield in Australia is in the

bottom half of the fives, I think, at the present. These rates go up and down but that is not materially different from the sorts of rates we have seen on average for a decade or so.

Senator JOYCE—Less than a per cent or more than a per cent or—

Mr Stevens—I think the effect, if any, is quite small. It is certainly not more than a per cent, no—much less, if anything.

Senator JOYCE—Is there any extent of government borrowings where it does have an effect, or are government borrowings irrelevant?

Mr Stevens—They are not irrelevant, but this is an area where over the years, in my memory at least, the studies which try to pin this down empirically find a pretty wide range of estimates and often they struggle to find much effect. I think that if we had much larger debt burdens, like 50 per cent of GDP or something like that, we would see a noticeable premium on Australian debt reflecting that, but I do not really think that one can claim that there is a significant measurable impact on these yields at present. These yields, presumably, embody the market's expectation of all the things that are ahead.

Senator JOYCE—Okay, say, 50 per cent of GDP. Now Australia's GDP is about \$1.2 trillion, so we are looking at about \$600 billion. Is that a fair analysis of what you are saying when you talk about debt levels of GDP?

Mr Stevens—What I am saying is that with debt positions of 10 or 15 or 20 per cent of GDP, the likely impact of that on the premium that our government pays over and above what other governments would pay is likely to be pretty small. The most likely cause of a big rise in government borrowing costs is the borrowing by other governments around the world. After all, it is a global capital market.

Senator JOYCE—I am not looking so much at the premium of what we pay to other governments, because other governments are in hock to their eyeballs as well. I am looking at the effect on the domestic borrower in Australia by reason of the largest purchaser of money in the economy being the Australian government. What is the percentage effect on them?

Mr Stevens—My point is that the Australian government borrows in a global market. There are free global capital flows here and the long rate in Australia is driven more strongly by what happens in global markets than by what happens here, frankly, at the sorts of debt levels we are talking about. If we were talking about much, much bigger debt levels that would be different. But in prospects—

Senator JOYCE—You mentioned 50 per cent. Australia's current federal debt is around \$100 billion or \$115 billion, and the states' debt is heading towards quarter of a trillion dollars, so we are heading way over \$300 billion already in government debt—and, as you know, but others need to be informed, the federal government has underwritten the states' debts—so we are well on our way towards having 50 per cent government debt.

Mr Stevens—I do not think that I agree with that.

Senator JOYCE—What is your view?

Mr Stevens—The 50 per cent anyway was a reference to federal general government debt—

Senator JOYCE—Just the federal government?

Mr Stevens—Remember the Maastricht Treaty that all the Europeans had to sign to get into the Euro area? It was a matter of whether they could or could not meet it, and that was for debt to GDP of 60 per cent. Actually, Australia would have walked in on that criterion had we been part of Europe. So this is a world where we have got the G7 group gross debt to GDP going to be 100 per cent pretty soon. We have got countries like Japan at 140 or 150 per cent and a number of countries in Europe not much different from that. We are talking about debt numbers for Australia in gross terms and even if you do add the states in I would have thought it would be significantly less than 50 per cent of GDP.

Senator JOYCE—But the budget position is for \$517 billion, half a trillion dollars. We have only got a \$1.2 trillion economy. We are getting up there.

Mr Stevens—Hang on, what is the \$517 billion? What figure is that?

Senator JOYCE—In the budget—and I have not got the papers before me because I am in Christmas Island—the gross long-term liabilities were to the extent of half a trillion dollars by 2013 or 2014.

Mr Stevens—I am not familiar with what that figure represents. There is not much argument that the state of the government accounts in this country is just so superior to virtually anybody with whom we would want to compare.

Senator JOYCE—Going back to the international state of accounts: all the money that has been borrowed obviously has to be repaid at some point in time. If we believe in the bona fides and the benefits of the stimulatory effect of money being injected into the economy, what is going to be the effect when all this money is taken out of the economy to repay the debt?

Mr Stevens—That is all built into the forecasts that people have. A certain, modest degree of debt servicing has to be paid for by the government each year. It is pretty modest.

Senator JOYCE—Have you decided on any form of exit strategy for the government as to how they are going to repay the debt?

Mr Stevens—The exit strategy is the long-term projections that they put out with the budget that show the budget returning gradually to balance and then surplus and the debt ratio peaking and starting to come down. That is the exit strategy. How do they get that strategy? I am not here to defend—

Senator JOYCE—Is it a schedule of repayments or is it just some sort of amorphous, nebulous basis that some time in the future the money will be repaid? Have you seen anything concrete on how the money is going to be repaid?

Mr Stevens—When the budget goes to surplus you are repaying debt. That is what that means. That tells you how that occurs. Of course, you could debate whether that will be delivered on that schedule—we do not know. What they have set out there is the exit strategy. Have I seen anything other than that? No.

Senator JOYCE—Has there been any statement about peak debt or about when federal debt will actually stop going up and start coming down?

Mr Stevens—That is the budget papers.

Senator JOYCE—Has anybody been decisive enough to implicitly state when that point will be?

Mr Stevens—There is an estimate for that in the budget documents. I cannot recall what year it is. It is some years out but there is a peak figure quoted in there and a year in which it occurs.

Senator JOYCE—Far enough out that we cannot be held to it in the short term is my recollection of it.

Mr Stevens—That is inevitable.

Senator JOYCE—In relation to the stimulus payments, if a portion of the stimulatory effect driven by the \$900 cheques were compared with the effects of exports and export dollars, what portion would it be?

Mr Stevens—The first round of payments—the ones in December, as I recall—was a little bit under a percentage point of GDP—about 0.8 or 0.9.

Senator JOYCE—What was the percentage of GDP for exports in that same period?

Mr Stevens—Exports are about a fifth of the economy, but you have to work out here what you think the counterfactual was. Exports did not really grow very much. The point about exports is that they did not decline by 10 to 35 per cent, like everybody else's exports did. That is the big point there.

Senator JOYCE—What portion of the economy's GDP was exports?

Mr Stevens—It is routinely about one-fifth.

Senator JOYCE—About 20 per cent. So the effect of the stimulus was less than one per cent?

Mr Stevens—The debate over the stimulus measure is that it was worth about eight-tenths of one per cent of GDP. Did people spend it and, if so, how much of it and how soon?

Senator JOYCE—Eight-tenths of one per cent?

Mr Stevens—Yes, to growth.

Senator JOYCE—How is eight-tenths of one per cent at all responsible or quantifiable against the massive effect of exports? How can a \$900 cheque be responsible for putting one tonne of coal onto a ship?

Mr Stevens—Senator, I think you are comparing things that cannot be compared. If I take the level of exports—it may be 20 per cent of GDP—and it does not grow, then it has not contributed to growth. If there is an impetus into the economy that is half a percentage point of GDP then that contributed to growth in that quarter of half a percentage point, whereas exports contributed no growth in that quarter.

Senator JOYCE—But a slight reduction in exports is likely to reduce exports by eight-tenths of one per cent, and that would have a massive effect. Obviously, the economy is being driven by exports, and three-fifths of five-eighths of hardly anything is what the effect of the stimulus package was. If exports go down by eight-tenths of one per cent, which would not be much of a change to the quantum of exports, then all the effects of the stimulus would be negated. That goes to the next statement: how do you reckon we will go with an emissions trading scheme which might do precisely that?

Mr Stevens—I have no comment on the emissions trading scheme. On the broader issue, it is quite true that had a very large fall in exports occurred it would have meant a much weaker economy than we have had. While I am not here to defend the stimulus package, I do not think that means that the stimulus package either was ineffective or should not have been done. That does not follow from that statement.

Senator JOYCE—It seems that the vast majority of the GDP is return on export dollars. Shouldn't there be a greater investment in what actually brings about those export dollars? Shouldn't that be a far greater investment in that than in what prospectively could have just been the purchase of imported chattels—imported retail goods?

Mr Stevens—Actually, 80 per cent of our GDP is produced at home. It is not true to say that most of the economy is a return on exports. A significant chunk of it is, but it is one-fifth, which, by the standards of many other countries, is low. We are not that open an economy in comparison to most in Asia or Europe.

CHAIR—Senator Joyce, we will have to go to Senator Xenophon now.

Senator XENOPHON—Mr Stevens, I will not ask you about the emissions trading scheme; it is slightly outside the scope of the terms of reference. But I will ask you about the issue of exports that Senator Joyce raised. How is the financing of the stimulus package impacting on the Australian dollar? At the beginning of last year, well before the global financial crisis, we saw the dollar collapsing; it is now relatively high. To what extent is the stimulus package relevant to the Aussie dollar?

Mr Stevens—We could think about a few channels there. If you were prepared to accept that the stimulus package adds to strengthen the economy—some people do not accept that—

Senator XENOPHON—You accept it, though.

Mr Stevens—I do, yes—then economies which are stronger rather than weaker typically have a firmer currency relative to what they would have if they were weak. One reason for that is that in such economies return on capital tends to be positive and higher rather than lower, which means that foreign funds find it attractive to come there. Of course, one dimension of that is that such countries, not always but typically, have a higher interest rate structure across the board than a country that is comatose. We have low but still positive interest rates, whereas Japan has them at zero as do a number of countries now. All those things are relevant to the exchange rate. The other factor that is relevant is that what we saw with the big fall from in the mid-nineties down into the low sixties was not just a change in view about the prospects for this economy, although there certainly was that change in view; it was a retreat from risk-taking behaviour across the board by investors around the world. In that sense, it was the same phenomenon in a way as the fall in share prices, the closure of many capital markets and so on. There is a class of investment behaviour which involves being prepared to take currency exposure to high yield currencies and commodity currencies like our own. That all retreated as well, and then some of it returned. That is part of the cycle.

Senator XENOPHON—Do you see the stimulus package repaying the debt of the stimulus package? Will that have any medium- to long-term impact on the Australian dollar, which in turn could affect our exports?

Mr Stevens—Will repaying the debt have an effect? It is not clear to me that we should expect any particular exchange rate effects there. I would have to think that through a bit. The government will make its servicing payments. On their projections, at some point the budget goes back into surplus, the debt starts to whittle down and so on. I would not make any particular assumption about what effect that process would have on the exchange rate.

Senator XENOPHON—Sure. Going to your evidence before the House of Representatives Economics Committee on 14 August, you said, ‘I am not terribly worried that there was too much fiscal stimulus.’ You went on to say:

If someone wanted to make the argument that there is a need for more fiscal stimulus from here, I do not think I would agree with that, based on the outlook as we see it, anyway.

That was 44 days ago. There are newspaper headlines today saying that there is going to be a \$10 billion turnaround in terms of the budget deficit. There have been a number of economic indicators since that time. Has your level of worry or otherwise changed since you made that statement before the House of Representatives committee?

Mr Stevens—What I was saying then was that the measures that have been implemented and that were in prospect on the plan that was set out earlier by the government is built into the outlook. I was not troubled by that outlook. In fact, I think that it is a rather pleasing one, because it is an economy that has had a pretty shallow downturn and has reasonable prospects for recovery. What I was saying was that if someone came up with a whole lot of new plans now to do more, I do not think that I would agree with that. I still would not. That is what I was saying.

Senator XENOPHON—But is the outlook more pleasing than it was 44 days ago when you gave that evidence before the House of Representatives committee?

Mr Stevens—We have not published a new set of numbers since then. The figures that we were speaking to then were the ones in here. After the next board meeting, we will publish some new ones. I am not sure what they will say yet. I have not seen the results of the staffs' work in detail. I doubt that they will be weaker. If anything, the way things that have been proceeding means that most people's forecasts will continue to edge higher. The \$10 billion recovery in the budget balance that is in today's papers, if that turns out to be true, will largely I assume be because these automatic stabilisers are kicking in as they should. They should be allowed to do that. If they want to return the budget to surplus faster than in the current projections, which they would if the economy is persistently stronger, then it would be best to let that happen rather than undertake some discretionary measures to keep the budget in deficit—certainly.

Senator XENOPHON—Given that about 15 per cent of the spending of the stimulus package is due in the 2011-12 year, if the outlook continues to improve is there a risk that we will overcook the goose if we continue to spend at that level? Is there a good case for at least re-examining spending for those out years—for the 2011-12 year?

Mr Stevens—There may be. I am not really in a position to speak in any detail on the particular proposed measures and on how easy they would be to turn off. I do not know the answer to that. We factor all these things in as time goes by and make our own adjustments. Our job is to make sure that the economy does not overheat and we will certainly do that job as best we can. As to whether there is a case for the government to have in their top drawer a kind of a plan B that seeks to wind this back faster next year, there might be. How feasible that is, I cannot answer.

Senator XENOPHON—Thank you. Finally, there is an argument about the quality of the spend of the stimulus package. There is an argument that some public moneys could have been spent better. I am not asking you to buy into that. But are there reasonable benchmarks? From your point of view, is there a way of assessing whether the long-term productivity capacity of the economy is better created by certain types of fiscal stimulus than other types?

Mr Stevens—In a perfect world, you would have a long list of infrastructure things that you would get out, dust off and turn on when the need comes. I have been through a few cycles now and I have not seen that happen quite so easily yet, because it is not feasible to do that. A government faced with a policy intention of filling in a hole in the economy that might last a year or 18 months is always going to face some degree of trade off between what you might think of as highest quality and maximum timeliness. I am not a fiscal expert, but I would be very surprised if we ever get away from that trade off completely.

Senator XENOPHON—Thank you.

Senator CAMERON—I will take us back to why we are here in terms of the fiscal stimuluses and the economic situation. I read a speech recently. It says that just after Lehman Brothers collapsed:

The six months following the collapse of Lehman Brothers last September saw the biggest falls in output for advanced economies since the Great Depression that so scarified people like John Curtin and Ben Chifley.

\$43 trillion was wiped off the value of global share markets in record time. The Australian Stock Exchange fell 8.3 per cent in just one day. Our dollar dropped by 16 per cent in just a week. The inter-bank lending market was shut down and, like dominos, the world's largest insurance company, America's fourth-largest investment bank and the world's largest providers of housing finance were bankrupted or bailed out. Entire banking systems were saved or nationalised ... Without the intervention of the IMF, half the banking systems of Eastern Europe would have gone under. By January, consumer confidence in the major economies had fallen to new record lows. Industrial production came to a shuddering halt. World trade collapsed. Six million Americans lost their jobs ... overnight. And 60 million in the developed world are still expected to lose their jobs ...

That is not a very edifying position. Professor Sinclair Davidson has challenged the Reserve Bank and the Treasury on the issue of why you did not see this coming. Given the devastation and given the challenges that are being put to the Reserve Bank, could you explain exactly why we did not see this coming?

Mr Stevens—There were not that many people who accurately forecast that sequence of events. After these sorts of events, it is normal to see a few people pop out and say, 'I predicted all this.' But I think that most of those claims could be taken with a certain degree of salt. What I would say is that if you go back several years there were people who were saying things like: 'There's leverage building up. There is very skinny compensation for risk being paid to investors. There's a lot of complexity here. We're worried.' The official community of supervisors and central bankers and those who think about stability said things like that for a few years. The thing that they could not do, though, was say: 'Not only do I have this concern but I can tell you how it's going to unfold. What will happen is that these American subprime loans will start to go sour. Then there will be a sequence of failures. Then there will be a retreat from risk taking. These concerns will spread to Europe. Then there will be a rescue of the No. 5 American investment bank, but then when No. 4 comes under pressure it will not be rescued. And then after that Armageddon will follow.' I am not aware of anyone who predicted a sequence of events like that.

Senator CAMERON—I do not think even Professor Sinclair Davidson did that.

Mr Stevens—I do not know Professor Davidson, but not many people would have predicted that course of events. But, once they occurred, some of us had to wake up that morning and work out how to respond.

Senator CAMERON—Professor Davidson and Professor Makin argued that we should not have gone to fiscal policy, that monetary policy should have been used more aggressively. Professor Makin argues that we should have reduced interest rates a further three per cent. Do you have any comment on that?

Mr Stevens—I always felt that we should be prepared to do some more if needed, and in fact we said publicly for some months that we think this is okay for the moment but we have scope to do more if that is needed. As it turns out, it was not needed. I am not sure personally that I would agree about finding the central bank with its interest rate at zero and then having to ask: what other things are we now going to do? I feel very, very pleased and fortunate indeed that I do not

find myself in that position. I think it is immeasurably to Australia's advantage that, however we have arrived where we are, we do not find ourselves with the overnight rate at zero, with the central bank feeling it needs to buy the government's debt outright and things like this. I am not saying that the countries that are doing that are doing the wrong thing, but I think it is much to our advantage that we find ourselves not in that place.

Senator CAMERON—Professor Leigh, in his submission to the inquiry, quoted the Brookings Institution analysis of Elmendorf and Furman to determine when a stimulus package should be implemented. He quoted that analysis and said that you have to look at effort required, when it is required, how it would be implemented and whether it would be timely, temporary and targeted. Do you think the response in Australia has met the analysis that Elmendorf and Furman have put forward in terms of an efficient and effective approach in response to this global financial crisis?

Mr Stevens—The three Ts—temporary, timely and targeted—are a standard set of desirable criteria amongst people who talk about this. I think it is pretty hard not to conclude that it was quite timely. It was very fast. The bulk of it is temporary. Notwithstanding the discussion earlier about 2011 effects, the big impacts are in 2009, which is presumably the year in which the economy would need the most support. On the targeting, that is probably where people are going to differ about just what should be targeted. That inherently is, I think, largely a set of decisions which are properly made in the political realm. It is the job of the political process to make that decision.

Senator CAMERON—When I was questioning Professor Davidson in relation to some statements you made in evidence to the House of Representatives committee, his response to your support for the broad strategy was that you are a government employee. I am not quite sure what he meant there but, given that it might have a reflection on you as the governor and your relationship with the government, I ask: there is no question you are acting independently?

Mr Stevens—I do not want to get into a debate with a professor who is not present or anything, but I can assure you that the bank has made its assessment of all these things with total independence. Policy decisions are made the same way, and that will continue to be the case while ever I have anything to do with it. I hope people do not really need to be assured of that, but let me assure you, if there is any doubt.

Senator CAMERON—I was just giving you the opportunity. The G20 issued a statement overnight in relation to the crisis, and they are saying we are now in a critical transition from crisis to recovery. That would seem to me to give an indication that there is still some uncertainty out there. I have read that there are significant banks in the US that still have toxic debt and that there is no definitive outcome that everything is going to be okay. Is that your view? Is there still some uncertainty out there?

Mr Stevens—There is for some of the major economies. I think that is correct. That is inevitably a feature of these sorts of episodes, and people are understandably quite cautious. I am probably at the margin. I am slightly more optimistic than many of those people, but we are really talking about the margin.

Senator CAMERON—But I suppose it is okay in hindsight. Everyone is saying that we should be removing the stimulus quicker and maybe we overreacted—that is some of the evidence that we have had. But, given what we faced in terms of the global economy, wouldn't it have been better to ensure that we did everything possible to safeguard employment? The banking crisis suddenly became a crisis in employment, and we do not hear much talk about what that crisis in employment means to individuals and communities. It is the difference between being able to put food on the table and not for many workers. I think we lose that a bit in the esoteric debate that goes on from time to time. So do you think that this country reacted in a professional and timely manner?

Mr Stevens—Insofar as my own institution, obviously I do think that. My perspective on that question, I guess, is that for policymakers—and I think this would be true for fiscal policy as well—certainly when we are making monetary policy, it is not just the central outlook, that the staff do a forecast for you and then you respond to that. If that is all it is, then you do not actually need a decision maker; the forecasters would actually determine the outcome on policy. But that is not all there is. There is also a sense of the balance of risks around that central view and what the consequences would be—the costs, of which the employment things you mention are one, although probably not the only one—if one of those tail outcomes occurs.

So in a period like we have been through I think policymakers ought to, and did, think about the potential tail risks and what costs would be associated, and the policy response was at least to some extent calibrated to the risks. You cannot ensure those risks do not occur, but maybe you can lessen their probability a bit, and if you can do that without damage to your central objective then I think that is probably appropriate. Certainly for my own part in thinking about our policy decisions that has been an important consideration. I assume that would probably be true for the fiscal decision makers as well. I think that is what did happen.

Senator FIELDING—Mr Stevens, thanks for being here. If the current stimulus spending continues, are we in danger of driving up interest rates?

Mr Stevens—Let us be clear about what the question means. The present level of spending is not scheduled to continue. That is a point. If I interpret your question literally, if the current spending did continue, then that would be a stronger outcome than everybody is assuming. If all other things are equal, a stronger economy usually does mean interest rates are higher than otherwise, but what is scheduled to occur is that the impetus from the fiscal plans is tailing off over time.

Senator FIELDING—You say it is tailing off, but there is still a huge amount to be spent over the remainder of this year, next year and the following year. You did talk about maybe how fast it will be if it is needed to wind it back. My question still remains: if the planned spending of the stimulus package continues, are we in danger of driving up interest rates faster than they would be otherwise?

Mr Stevens—As I said in my opening remarks, I think we will need to see a wind-back of both fiscal and monetary expansion over the period ahead. If things proceed as we presently expect, that will mean that interest rates will go up. Now in the hypothetical world where suddenly the government decides, 'Let's adopt a much more aggressive cutback in fiscal,' maybe we will cut all the spending right back or have a tax increase or something and turn the budget

around much faster. That probably would have some bearing on the trajectory for interest rates. It is a separate question whether that is a better outcome, but in that hypothetical case, if you do enough on one arm the other arm will seek to compensate. That has to be true.

Senator FIELDING—Let me cover it from a different angle, if I can. There is pretty well accepted view that interest rates will probably move in the upward direction over the next year or two. Is there anything the government can do to reduce the likely effect of putting pressure on interest rates going upwards? Is there anything they can do to avoid that?

Mr Stevens—I would wonder whether we really want to avoid interest rates going back towards normal over that time because I am not sure it is a good outcome to have them persistently low for a long period.

Senator FIELDING—But the issue is how fast they go up.

Mr Stevens—Yes, sure. Is there anything they can do? In principle, at the level of logic, of course I guess they could take a sequence of decisions which slow down the demand in the economy which would otherwise be occurring and that would presumably have some impact on the outlook, including for inflation, and therefore we would be on a different course from the one we would otherwise be on. So in principle that is possible. I still think though that one should also ask the prior question of whether that is a better set of outcomes. Is it the best outcome to have a huge budget surplus and very low interest rates? There is often a presumption that that is good. I am not sure I share that presumption because there are things that go wrong with very low interest rates and there are possibly reasonable things that the governments can do with the money. I am a bit reluctant to accept that presumption.

Senator FIELDING—The issue though is how fast they go up. We know for example that mortgage stress is already out there at interest rates the way they are currently, obviously due to the economy, but how fast they increase is going to impact a lot of people. The reason I am asking is that, if we continue to spend the stimulus package and it proves to be more than what is needed—obviously that needs a crystal ball—and it has the effect of putting pressure on interest rates and driving them up faster than they would have otherwise, you can see why Australians will be asking the question. We are all happy to spend stimulus money if it saves the economy, but by the same token we have to look at whether we need to wind some of it back in the future if it is overspending.

Mr Stevens—That is all eminently logical, but let me add that mortgage stress has actually gone down in the last nine months, in large part because interest rates fell. At this point I do not hear anybody, including us, saying that an early return to the peak interest rates of early 2008 will happen in the near term, unless the economy really astounds all of us dramatically. In the near term, I do not think that is the likely prospect. There has been some mortgage stress, but let us keep that in perspective. It is a serious problem for those who have it, but we are not talking about the majority of households. We are talking about a few tens of thousands of households, which is a lot, but compared with the seven million total it is not that many.

Senator FIELDING—You mentioned before that, if the government had a plan B in the top drawer of winding back the stimulus package faster, they may have—I am not saying they do; it was a hypothetical type of thing.

Mr Stevens—I do not know if they have.

Senator FIELDING—I understand that. What was the rationale behind that? Obviously there is a bit of a feeling out in the community that they are just not sure. I think most of the community believe that we needed to spend what we have spent to try to protect the economy, but there is this feeling out there about how much more we should spend and whether we really do need that plan B. When do you think is the best time to bring out plan B or to consider a plan B in winding back some of the stimulus spending?

Mr Stevens—Whether they need a plan B or whether one should be implemented is, of course, a topic of debate. The government have a budget once a year. It is now September but, from memory, it is not that long from now that the processes for the build-up to that will get going. So, presumably, if there is any plan B or some other plan for fiscal measures, that is when we will hear about it. That is the normal schedule.

Senator FIELDING—There is a view that, rather than stop the spending, it could just be deferred and allowed to roll out over a 10-year period rather than over a shorter period. Do you have any views on that?

Mr Stevens—If you have a concern about overheating in the next year or two, I guess some deferral might have some attraction. But that is a very general idea; there are no specifics here. It would probably have some implication for other bits of spending you were already planning for in year five which you might have to rethink. Who knows?

Senator FIELDING—Thank you.

Senator RYAN—One of the challenges of going last is that some of your questions have already been asked. I want to clarify an issue on which Senator Fielding asked a question, which is the link you referred to earlier between the one arm of fiscal and the other arm of monetary, that, in the absence of there being \$20 billion or \$30 billion over the forward estimates of remaining stimulus spending, interest rates would otherwise be potentially lower—not that you would necessarily say that was a good thing and you did allude to some of those problems—but that a tighter fiscal policy would likely lead to less pressure on the need to raise interest rates in either the quantum or the speed, to what you would call a neutral level.

Mr Stevens—I think that, if we consider a hypothetical world where none of this had been done, interest rates would have gone down more—I think that is right—and they would have more to go up to get back to normal in due course as well. Is that a better outcome than the one we have had? That is a very different question.

Senator RYAN—Earlier you said that the Reserve Bank—I think the words were—‘take fiscal policy as a given’.

Mr Stevens—Yes.

Senator RYAN—If we look at the forward estimates and take out \$20 billion or \$30 billion of remaining stimulus spending between now and the end of 2011-12 and take that as the given fiscal policy, would interest rates likely be lower or have risen more slowly?

Mr Stevens—If the presumption is an impact on demand that is \$20 billion or \$30 billion less, over three years that is a level of demand that is nearly a per cent of GDP a year lower. So, all other things being equal, the course of the economy would be a bit different. What we are responding to is total demand, more or less, rather than where it comes from. It is really the total that counts most. So in that hypothetical scenario, yes, I think that would have some bearing on the future path of interest rates. It is a bit hard to say how much—

Senator RYAN—I appreciate that.

Mr Stevens—but in principle that has to be right. We have had this debate many times in various parliamentary committees and that is always the answer: yes, demand matters and if demand is materially weaker or stronger, presuming that is not just very temporary, then monetary policy has to take that into account of course.

Senator RYAN—And the size of a deficit or the status of fiscal policy does impact that.

Mr Stevens—It is not the deficit per se.

Senator RYAN—No, it is the relative stance of fiscal policy.

Mr Stevens—It is the fiscal impact on demand over the relevant horizon. We have to try to form an assessment of that, just like we form an assessment of the Chinese demand for exports and so on and so forth. Like all of those things, it is one of the bits of the story.

Senator RYAN—Thank you. You mentioned earlier that the global long-term government bond rate is set by the US Treasury and whether Australia is above or below that by a little bit of a margin is predominantly out of Australia's hands. I think you said—and I am paraphrasing—that, if it were to rise, it would not likely be due to the situation caused by the Commonwealth; rather it would be due to other nations that have accrued more debt. I was wondering, though: Australia is a large borrower in total terms, is it not, including in the private sector, relative to its size? We are highly dependent upon the influx of foreign capital.

Mr Stevens—We have a substantial degree of capital inflow each year, as we have had virtually since Captain Phillip arrived. That is true, and it is because we have got a lot of investment opportunities in this country and the capital finds it attractive to flow here.

Senator RYAN—I appreciate that. Does it not also mean that for continued economic growth we are actually dependent upon that inflow of capital for the investment opportunities that you mentioned?

Mr Stevens—If we want to do the investment and not give up current consumption more in order to fund the saving, that is right.

Senator RYAN—It strikes me that there is a constant comparison between the state of the Australian government and that of other governments that are more in hock—to use the term that Senator Joyce mentioned—which may not be the fairest way to compare the relative risk to the Australian economy, as was alluded to last year when the government introduced its wholesale banking guarantee because our banks needed to access such significant sums of offshore capital

to maintain their balance sheets. Don't you think that, by simply doing a government to government comparison, we do not actually understand the whole risk to Australia of a long-term increase in interest rates?

Mr Stevens—It depends what question we are asking. If we asking whether the government itself is on a path of solvency, then I think the relevant comparison is our debt-to-GDP ratio compared with others. If we are asking about the typical extent of foreign capital inflow, how sustainable that is, and how vulnerable we are to a shock, that is a different question and I am not sure it actually has much bearing on fiscal policy. It goes to a whole lot of different things, mainly how well we use the capital that comes in, which is mainly in the hands of, obviously, the businesses and households.

Senator RYAN—Or in this case, surely, the government as well, if it is borrowing offshore to actually fund, for example, \$900 payments?

Mr Stevens—Well, it is having its tenders for Australian dollar debt in Australia. Foreigners may or may not buy that. It is not that the government is running off to New York, as far as I know, to raise US dollars or something, which is what typically happened decades ago. That is not what happens now. It has some tenders and the debt is sold in the local market, possibly to foreigners, possibly not, depending on appetite on the day. It is not that easy to demonstrate a very clear link between the size of government borrowing and the total amount of capital flow coming in. We had that debate back in the eighties and, basically, the twins deficits are not really twins.

Senator RYAN—Sure; I appreciate that. The government is undertaking substantial borrowings in an era where, over the coming years—I think you or one of my colleagues mentioned this earlier—there may well be increased pressure on long-term interest rates because of the demand all around the world. Do you believe that there is a risk of crowding out the private sector when its demand for borrowing does return as the economy strengthens?

Mr Stevens—I was saying before that of course there is some potential for that risk. One can hardly deny that. The question really is, quantitatively, how big that is. My point is that the thing which is most likely to crowd out Australian businesses and other businesses by pushing up the long-term global interest rate—it is not going to be the Australian government's contribution to borrowing, unless it is a lot bigger than it looks like being—it will be the huge run-up in public debt in the major countries, which are quantitatively so much larger.

Senator RYAN—But the Australian taxpayer is now exposed to that risk, whereas without this level of borrowing it is fair to say they would not be directly exposed to that risk. Isn't that correct?

Mr Stevens—If you never borrow, you are never exposed to a risk of interest rates rising. That is true. But, currently, the government is selling 10-, 12- or 14-year debt at about 5¼ per cent, which is the normal rate for Australia. That rate, which is prevailing right now, presumably reflects the market's valuation of all these risks that you are talking about. That is in the price, because that is what these guys are paid to price. At this point, that rate does not look to me to be unduly punitive. I do not think at the moment that is crowding out anybody. The bigger picture here—and this is more true for governments elsewhere—is that there is a logic, when the private

sector suddenly does not want to borrow and wants to contract and de-leverage, for someone who has a strong balance sheet to come in and temporarily go in the other direction, not permanently but just for a temporary period. That is a stabilising thing to do, and the trick will then be, as we have been talking about, to know how to stage the exit from that when the private sector is more confident and ready to go back into investing and borrowing.

Senator RYAN—Finally, before this crisis hit, Australia was experiencing a growth rate of two to three per cent, which saw a period of tightening of monetary policy, due to various factors, as late as early 2008. The budget estimates forecast a return to surplus and paying back this level of debt and it actually forecast a much higher level of growth, above four per cent. What would be the differences that you would need to see to ensure that did not lead to a much higher level of interest rates and a more rapid tightening of monetary policy?

Mr Stevens—Let us establish some facts here. The growth rate of demand in the economy, leading up to the middle of 2008, was more like four or five per cent. GDP was growing slower than that because the net trade position was going backwards. Our position of course, as you know, was that that pace of demand was clearly in excess of the economy's potential supply growth and that inflation would rise and indeed it did rise, way too high. The thing to keep in mind is that if you have had a recession or a significant period of below trend growth, it is normal to expect a period of above average growth—it is not permanently above average, it is just above average for a while—while you wind in the spare capacity, the unemployed that Senator Cameron referred to, and then you have to slow down to trend. I do not want to try to defend particular year by year numbers in those projections, but it is not unreasonable to expect a bit of above trend growth for a while. That is part of a normal business cycle.

Senator RYAN—The expectation of above trend bounce back following a downturn, however, would also be lower if the downturn was more shallow, would it not?

Mr Stevens—That is correct.

Senator RYAN—There are those who saw forecasts of four per cent growth for quite a number of years, in fact for more years in the estimates than had happened in the last 20 years, but it would be odd for there to be a sustained period above four per cent growth without demand becoming a matter of concern to the Reserve Bank?

Mr Stevens—The closer we start the upswing to the level of potential output then obviously we are starting a bit closer than was assumed and the fewer number of periods of above trend growth you could reasonably expect to follow in the future. I certainly agree with that. I would imagine that, once those projections are all updated, you will see the near term ones higher but some of the out ones would have to be lower for exactly that reason.

CHAIR—At this point we will conclude. Mr Stevens, we thank you very much for your time this morning. You have been very generous. We have gone over time, but it has been a very useful segment.

Proceedings suspended from 11.18 am to 11.33 am

HYDEN, Mr Neil, Chief Executive Officer, Australian Office of Financial Management

JOHNSON, Mr Andrew, Head, Compliance and Reporting, Australian Office of Financial Management

CHAIR—Welcome. Would you like to make an opening statement?

Mr Hyden—Thank you. The main area of the inquiry's terms of reference that is relevant to the Australian Office of Financial Management is the term of reference that relates to the anticipated impact of stimulus spending on future taxpayer liabilities. The 2009-10 budget papers provide the most up-to-date official information available on projections of Australian government net debt. The debt issuance by the AOFM so far this financial year has been broadly in line with those projections. We will review our issuance program when the Mid-Year Economic and Fiscal Outlook is published by the government. In broad terms, we do not have any further information than what is available in the budget papers. That is the only introductory comment that I wish to make.

CHAIR—Thank you. Mr Johnson, do you wish to add anything?

Mr Johnson—No.

Senator JOYCE—Mr Hyden, what is the amount of Australian government securities outstanding in notes and bills?

Mr Hyden—I am trying to recall the most up-to-date figure. It is somewhat in excess of \$100 billion.

Senator JOYCE—You do not have anything on where we are right now? I know it is in excess of \$110 billion.

Mr Hyden—I think that is right. We do put monthly figures on our website, but I do not have the latest figures in my mind.

Senator JOYCE—Can you inform me what we have underwritten and what the state government debts are at this point in time?

Mr Hyden—Again, I do not have the specific number in mind, but I have a general impression of around \$120 billion.

Senator JOYCE—I thought it was slightly more than that. I do not mean net debt but the gross debt of the states.

Mr Hyden—That is my recollection of the gross debt. It may have changed a little due to issuance changes.

Senator JOYCE—I know Queensland has got about \$85 billion and New South Wales has got about \$60 billion or \$70 billion, so it has got to be far in excess of that. I think it is around \$230 billion, but I just wanted to get close to it. What has happened to the yield on the bonds and notes we are issuing? What is the yield return?

Mr Hyden—I think the yields on a debt have remained fairly stable over the last couple of months. Mr Johnson may have some figures he can give you.

Mr Johnson—Currently a 10-year bond is around 5¼ per cent. That has increased by around 80 basis points since the budget time estimate. I assume that is the reference point you would like.

Senator JOYCE—Is that the same comparative increase in yields in other key countries such as Singapore, Japan or the United States, knowing that the United States is in a world of trouble with debt?

Mr Johnson—Sorry, Senator, I do not know that one. Mr Hyden may.

Mr Hyden—The factors influencing interest rates in different countries are quite varied so we do not attempt to follow those in detail. I do not think I can comment on how far the movement and rates here reflect those overseas.

Senator JOYCE—So there is a differentiation in what changes in yield there are in Australia to what happens overseas?

Mr Hyden—There are some factors which are applicable here and there are other factors that are relevant in individual countries elsewhere. In particular, the relative strength of the economy and the expectations about inflation and exchange rates can have an impact.

Senator JOYCE—So domestic policies in Australia affect our yield rate. We are not completely at the behest of and the beck and call of international issues. What we do domestically can affect the price of money in Australia.

Mr Hyden—Yes, and, in particular, what happens to Australia's inflation and expectations about inflation are important for the level of nominal interest rates in Australia.

Senator JOYCE—Mr Hyden, when do we expect the current \$200 billion facility to be fully drawn?

Mr Hyden—Which \$200 billion facility is this?

Senator JOYCE—The \$200 billion appropriation that we did in the second stimulus—in the vote on the second stimulus. When do you expect that money to be fully drawn?

Mr Hyden—I do not have a specific projection on that, but it would, I think, take us into about the year 2011.

Senator JOYCE—Roughly, how many billions are we drawing down a month now?

Mr Hyden—Currently about \$5 billion a month.

Senator JOYCE—About \$5 billion a month.

Mr Hyden—I am talking there essentially in terms of treasury bonds and treasury indexed bonds, which we have not been issuing but we are currently planning to do so. The \$200 billion relates to the total amount of debt outstanding at any time. Our issuance of treasury notes can be part of that but, as they are short-term instruments, it is really the change in the total volume of notes that is relevant in that connection.

Senator JOYCE—Do you know what the comparative yield is on US notes at this point in time?

Mr Hyden—I do not have that figure with me.

Senator JOYCE—With regard to the rating of Australian securities, how are we currently rated? Where are we on the list of preferable purchase or preferable bond? I suppose that relates to the rate.

Mr Hyden—We are rated by the rating agencies in their highest category, which is generally labelled as AAA. Several of the agencies which have published analyses or commentaries on how they regard and rate sovereign governments that are within the AAA category are tending to put us towards the top ranks of those AAA-rated sovereigns.

Senator JOYCE—Can you give me an approximation of how many countries are in that group and whereabouts we are in that—for example, No. 7 or 8 out of the first 10 or something like that?

Mr Hyden—I am not sure that I can give you a precise number. I think there would be about a dozen AAA-rated sovereigns that are substantial issuers of debt. We would be in the highest group of those. Different rating agencies have different approaches or different commentaries as to how they would group us, but they may put us in the top two or three or something like that.

Senator JOYCE—As to the expectation of rating agencies, do they look at your capacity to meet as required your own sort of budget fundamentals of exit strategies on debt or your capacity to run off debt, or is that not a big issue for them? Do they look at your capacity to repay your debt?

Mr Hyden—The level of debt and the government's ability to make the principal and interest payments due on it are clearly a prime concern of any rating process. For AAA-rated issuers, it is almost axiomatic that they regard us as having a very high capacity to meet those requirements. They tend to look beyond that to the possible extent of shocks to the economy and the capacity of the economy—including policy responses—to adjust and accommodate to those shocks. Australia is rated very highly in those regards.

Senator JOYCE—Are we meeting our interest and principal repayments in any way, shape or form, or are we just extending debt—capitalising our interest and extending our principal?

Mr Hyden—We are certainly meeting all obligations as they fall due. In absolute terms, of course, the total amount of debt, or net debt, is increasing, and that reflects the budget position.

Senator JOYCE—More simply, for the purpose of the *Hansard* and those listening, how are we paying our interest? Are we borrowing more money to pay our interest? Where is the money coming from to pay our interest?

Mr Hyden—The government accounts are all in one pool, called the consolidated revenue fund, so there is no distinction as to whether a dollar paid in tax is used to pay interest or whether it comes from a dollar that has been raised as borrowings. But, as I said, overall, our total borrowings are increasing.

Senator JOYCE—Is our gross debt going up by more than our interest bill?

Mr Hyden—Yes, it is—because the budget is in deficit.

Senator JOYCE—And you are envisaging the budget to stay in deficit until when?

Mr Hyden—The Australian Office of Financial Management do not make any forecasts about budget; we take the forecasts published by the government. They show the budget as remaining in deficit to the forward estimates period.

Senator JOYCE—With the extent of other nations and their debt, which I acknowledge is far greater than Australia's—but it is just a matter of their fever being higher than our fever, with both of us sick—what is the effect on that and your capacity to access funds on the marketplace? Is there a sense internationally that this debt is part of the puzzle of the financial crisis—with everybody pretending that it will disappear and go away? Ultimately, this debt internationally has to be repaid. What views are coming back, or do people just work on the belief that somehow this debt will just hang around forever and no-one will ever have to repay it?

Mr Hyden—I think it is hard to make generalisations on that question. Over the last couple of year since the onset of the financial crisis two important things have been happening. One is an increase in borrowings by a large number of governments, but the second effect, which has coincided with it, has been changed attitude to risk on the part of many investors which has led to a flight to quality and safety. So there has been an increased availability of funds for investment in government debt. While governments have had a very much increased volume of borrowing, that has been able to be satisfied by an increase flow of funds into the sector. All of these processes come to an end, and there are some concerns overseas about the levels of government debt in some countries—which have reached historically very high levels. Australia's level of debt by comparison is relatively low compared to GDP, and I think there is a high degree of confidence in markets and by investors that we will be able to manage that debt effectively.

Senator JOYCE—Where exactly is all this money that is flowing into Australia coming from? We know it is coming from overseas, but can you tell from what source the largest portion of it is coming from and to what proportion, and what the second largest source is? Maybe you could give me the top three, as best as you can do it.

Mr Hyden—Part of it is coming from overseas. The figures that we have from the ABS have in the past generally shown that about 60 per cent of the total amount of Australian government debt outstanding is held by non-residents and the remainder by residents.

Senator JOYCE—Which is the largest holder of the debt?

Mr Hyden—We do not have any breakdown provided by the ABS of its data there. My impression is that that debt is fairly widely held. In particular, there is a large part in Asia, a large part in Europe and a significant amount in North America. There is no one market that dominates, but I would expect that the largest component of the outstanding debt held by non-residents is held in Japan. That has traditionally been one of the largest sources of funding for Australian government debt. China is also of growing importance, as are various countries in South-East Asia. In Europe there is a very large take-up in the London market, but a lot of that is on behalf of what I might call global investors or global fund managers, so the funds might originally be coming from right around the world.

Senator JOYCE—Just so I can clearly understand you—to make the figures easy, it is about \$110 billion—of \$110 billion you are saying that about \$66 billion comes from overseas and the rest is financed domestically. Is that your evidence?

Mr Hyden—I was saying that in the past the share held by non-residents has been around 60 per cent. The amount varies from quarter to quarter. In the last couple of quarters, which includes the period since we increased the size of issuance quite significantly, that share has tended to fall back and has become lower. We are not entirely clear on why that is happening. One element there is that the figures include our issuance of Treasury notes, which are short-term instruments and which I think are more likely to be taken up by domestic investors rather than overseas or non-resident ones. But even if we take that influence out of the figures, which we can do because of the way they are published by the ABS, there is still a fall in the proportion of the long-term debt that is held by non-residents over the last couple of quarters, so I think that is more like 55 per cent in the latest figures that we have, which are those of the June quarter. Whether that will be sustained I do not know.

CHAIR—I think we are going to have to move on to other senators.

Senator JOYCE—So you are saying 45 per cent is held domestically and 55 per cent by non-residents. Let us just go back to the \$110 billion. Forty-five per cent of that is going to be \$49.5 billion of domestic money that would be going to domestic banks but is now going to prop up the Australian federal government.

Mr Hyden—We are talking about a stock of debt, so this is money that is already invested.

Senator XENOPHON—I have a supplementary question to Senator Joyce's question. In terms of this mix between overseas investors, if you like, buying our bonds and the like and domestic investors doing so, what impact does that have on the Australian dollar and on interest rates—but more particularly on the exchange rate?

Mr Hyden—All of our debt is issued in Australian dollars so that non-residents who purchase that debt have to find Australian dollars to buy it from us. Some non-residents have domestic

sources of funds. For example, we may have insurance companies that are owned overseas but which generate Australian dollars from the sales of insurance or superannuation policies. It is hard to say that there is any systematic impact on the exchange rate or on the balance of payments.

Senator XENOPHON—But as a general principle, if more money is coming from overseas to invest in our bonds, would that tend to have the effect of propping up the Australian dollar?

Mr Hyden—It depends on what else is happening to the flow of funds in and out of Australia. To the extent that there is a reduction in inflows of funds—for example, in investment in equities or investment in infrastructure projects—then an increase in borrowing by the Australian government that is funded from overseas would be offsetting or balancing the other factors that were occurring. You have to look at the whole picture.

Senator HURLEY—Mr Hyden, I think Mr Stevens said during his evidence about government debt rates that long rates are unusually low. I think that is what he said. Is that your understanding as well?

Mr Hyden—No, my recollection of what he said—

Senator HURLEY—You are probably much more accurate.

Mr Hyden—was that the current rates at the longer end, or the 10-year rate, are broadly in line with past levels over the past 10 years or so.

Senator HURLEY—Perhaps where I misunderstood him was when he was saying that despite the fact that it is expected that governments overseas will increase their demand for debt, the interest rates, including in the longer term, are staying relatively stable.

Mr Hyden—Yes, rates in Australia for government debt, certainly at the longer end, are broadly in line with past experience. In some countries overseas, rates are lower than they have been in a longer perspective, but that reflects the distress in some of the economies.

Senator HURLEY—Can you explain how that would push down rates in the longer term?

Mr Hyden—It is largely a reflection of the flight to quality—that is, investors are seeking to put their money into relatively safe investments and, despite the levels of issuance by governments, that governments are still seen as high-quality debt. Many of the countries that have large issuance are AAA rated or maybe AA rated, so they are high-quality investments when you compare them with what other alternatives may be around. It is a matter of supply and demand.

Senator HURLEY—And as you said before, Australia is considered one of the high quality countries where people feel safe to—

Mr Hyden—Yes.

Senator HURLEY—There has been an increasing number of private equity raisings in Australia. Has that affected your ability to sell government debt?

Mr Hyden—No, they appeal to different sectors of the investment market.

Senator HURLEY—So you have no difficulty in dealing with the amount of raisings that you are being asked to do by the government?

Mr Hyden—We have been quite comfortable with the increased volume of debt issuance. Obviously it was a big jump to go from issuing merely to maintain the market rate of about \$5 billion a year to the current year, where we are looking to issue \$60 billion. But that has been accommodated fairly smoothly.

Senator COONAN—When will the register of holders of Australian government debt be available for public scrutiny?

Mr Hyden—We are looking at what action we should take in response to the legislation that was passed in June in conjunction with the Treasury and the ABS as to what options we have in that regard. It will be some way off before we will be able to take any action on that. There are some substantial questions and concerns in our minds as to whether it is practicable to introduce the register in the way the legislation sets out.

Senator COONAN—Are you able to give some time frame? Is it weeks away or months away that you would be able to give some definitive view about how the register will be implemented?

Mr Hyden—That is something that we are discussing with Treasury. I do not have a particular indication that I can give as to how long that would take, but our discussion so far have indicated substantial problems which we are not seeing ready solutions to.

Senator COONAN—I am interested to know what the time frame is around a response. There has been an amendment; it is now in legislation. Obviously if there are insuperable difficulties, one wants to know about them sooner rather than later, rather than have some eerie silence that has followed the passage of that amendment. So can you give me some idea about when we might hear back as to how or whether or when this register is going to be available for public scrutiny?

Mr Hyden—In the first place, that is a matter for the government. From our point of view, we have not identified a ready means of implementing the legislation. The legislation does specify that the register must be in a form prescribed by regulations. Since no regulations have been made as yet, we cannot proceed to establish a register. We also have not any resources allocated to that task. But the bigger questions are: how to do it, what would work and how would we do it in a way which avoids frightening off investors who might not want to have their investments disclosed publicly.

Senator COONAN—Are you working on the regulations?

Mr Hyden—That is a matter for the Treasury, it is not a matter for AOFM.

Senator BOB BROWN—I have two areas. The first is the AAA ratings. How do we rate compared with the United States?

Mr Hyden—Both countries have AAA ratings.

Senator BOB BROWN—And on the pecking order, are we below or above or on a par?

Mr Hyden—It is a little hard to pin the rating agencies down on that, basically they just give the ratings. The fiscal position of the United States is obviously weaker than Australia's in relative terms. It is looking at the size of the budget deficit and the accumulated level of debt. On the other hand, the US has a very strong and diverse economy and the rating agencies take that into account. One rating agency would clearly rate Australia somewhat ahead of the United States on my interpretation. Another rating agency I found a little harder to be clear as to just what their views are.

Senator BOB BROWN—I am just questioning on this, because obviously this recession began in, and was an outcome of, the United States economy, not ours. We did not have Lehman Brothers, let alone a General Motors. How on earth can the rating agencies have the United States on a par with Australia, considering our resource base and our economic performance?

Mr Hyden—I am not sure that I can answer that question on behalf of the rating agencies.

Senator BOB BROWN—Did any of the rating agencies, that you know of, pick the Lehman Brothers collapse or the recession?

Mr Hyden—I cannot answer that, Senator. I am not sure what their rating was before they collapsed. I do not think it was fully reflected. It was not reflected in their ratings.

Senator BOB BROWN—The other question I wanted to ask you—it is a little bit to the side—

Mr Hyden—Perhaps I could just add to that that some of the rating agencies take into account in their ratings of private firms—particularly large financial firms—some consideration of what support the government might provide in the event that the firm did get into financial difficulties. The outcome in Lehman Brothers case, where there was no support provided, was a big surprise to many in the market.

Senator BOB BROWN—By the way, are any of the rating agencies based outside the US?

Mr Hyden—There are rating agencies in a number of countries but—

Senator BOB BROWN—I am talking about the big three.

Mr Hyden—the three global rating agencies—the three largest rating agencies—that attract the most attention are US based agencies.

Senator BOB BROWN—Do you rate the rating agencies?

Mr Hyden—We do take account of the rating agencies' ratings when we are making our own investment decisions and we look at the differences between rating agencies, their different methodologies and the different meanings that their ratings may have. We also make our own assessments to some extent. So, we are not looking at the rating agencies uncritically but we have not attempted to rank the ratings agencies.

Senator BOB BROWN—But they are obviously rankable.

Mr Hyden—They may well be incommensurate—

Senator BOB BROWN—Do you think it would be a healthy thing for you or some independent global watchdog to rate the rating agencies, given their performance in the last couple of years?

Mr Hyden—I think it would be an extremely difficult task. I think in reality—

Senator BOB BROWN—If I may ask you, would that be more difficult than to rate the performance of other watchdogs or other corporations or entities?

Mr Hyden—I think it would be, because when a rating agency is rating a company, or whatever, it is evaluating the risks, and one can assess how those risks work out in practice. If one is rating the rating agencies one has to go behind those judgments and ask, 'Well, how do they compare with the outcomes?' The market does, in effect, make its own judgments. They can be seen, I suppose in the pricing of the instruments of companies or sovereigns and they can differ a bit at times from the rating agencies' ratings.

Senator BOB BROWN—On the matter of hypothecating bonds, for example in an age of climate change, the potential for a government to entertain green bonds—where bonds were issued for an ethical purpose, as we see in that private sector—is that an option?

Mr Hyden—I think, from the point of view of debt management, it is the total amount of debt that you have to place that is the important thing. The hypothecation, I think, is more a matter of fiscal policy—how far particular sources of revenue or funding more generally are tied to particular uses of those funds.

Senator BOB BROWN—What about ethical policy?

Mr Hyden—I think that is a policy matter itself. If you are saying, 'Would it be easier to sell or place bonds if investors were assured that the proceeds would be used for particular policy purposes rather than other ones?' there may be some investors who would attach some value to that, but in terms of the overall market I think it would be a relatively small effect.

Senator BOB BROWN—Do you know if that has been tried?

Mr Hyden—I do not know of any specific instances.

Senator BOB BROWN—Thank you.

CHAIR—Senator Xenophon has a couple of quick questions and then we will have to wind up because, surprisingly, we have come to the end of the time we have for this section.

Senator XENOPHON—Yes, I will be very quick. Following on from Senator Bob Brown's line of questioning about the whole issue of rating agencies, it is axiomatic that your office undertaking financial risk management is a key part of what you do.

Mr Hyden—Yes, it is an important part.

Senator XENOPHON—It is an important part of what you do. And, in order to carry out that function, you rely on rating agencies for the information they provide you, in part.

Mr Hyden—We look at the rating agencies as far as our investment activities are concerned. The largest part of our activities is concerned with debt issuance, so we are not concerned with the rating agencies in that regard, other than that we highlight the high ratings we have as part of our promotion activities.

Senator XENOPHON—Sure. But, insofar as they relate to the investments that you do, rating agencies have been important in terms of undertaking your role in risk management? It is a fairly basic proposition.

Mr Hyden—They are important for our credit risk.

Senator XENOPHON—Yes, sure. Further to Senator Bob Brown's line of questioning, given how woeful rating agencies have been in terms of their track record in the last 18 months, is there a new strategy on the part of the office to review the credibility of the information that you receive from rating agencies in terms of investments?

Mr Hyden—The investments that we have undertaken have been mainly in two areas. One is short-term money market instruments amongst Australian financial institutions, and we are currently focused only on the very top end of that market, so the rating agencies' input into that is a relatively minor one. We are confident in the quality of the instruments that we are investing in. The other area in which we have invested in the past but in which we do not have any investments at the moment is state and territory government and kangaroo bonds. We feel we know the state and territory governments pretty well. We have taken more account of the ratings attached by rating agencies to issuers of kangaroo bonds, which are largely overseas governments or international institutions.

Senator XENOPHON—Finally—because I am very conscious of the time—given the track record of rating agencies since this crisis unfolded, is your office more wary of or has it changed its approach to those rating agencies?

Mr Hyden—I think we are always cautious about—

Senator XENOPHON—More cautious now?

Mr Hyden—how much reliance we place on rating agencies, and we did do some extensive due diligence of our own. But the information collected by rating agencies and their analysis, as

distinct from their specific conclusions, provide a very accessible source of information and facts about the companies—

Senator XENOPHON—But you are a bit warier of their conclusions now?

Mr Hyden—So we are more cautious, yes.

Senator XENOPHON—Thank you.

CHAIR—That concludes this segment. We thank the Office of Financial Management for appearing, and no doubt we will see you in a few weeks at estimates.

[12.15 pm]

ROBERTSON, Mr Rory David, Economist and Division Director, Macquarie Bank

CHAIR—I welcome Mr Rory Robertson and invite him to make an opening statement.

Mr Robertson—Good afternoon. I work as an economist at Macquarie Bank here in Sydney and appear before the committee today as someone whose job, for more than two decades, has been to observe and analyse the economy, financial markets and macroeconomic policy. For the record, I worked for six years from 1988 as an economist with the Reserve Bank of Australia, followed by a decade and a half in the finance sector as an economist with Bankers Trust and now Macquarie Bank. For my first four years with Macquarie I was based in New York. Thank you for your time this afternoon. I am appearing today in response to an informal invitation from the Secretary of this committee. I do not claim to have a great expertise on fiscal policy but I will do my best to explain the extraordinary economic situation in which it has been operating over the past year.

CHAIR—Mr Robertson, I am sorry to interrupt you but we do have a copy of your opening statement. Perhaps you could just run through an overview and then the senators can ask you questions. You appear to be reading that statement.

Mr Robertson—Yes, I am reading it. Would you like me not to read it?

CHAIR—We are very interested in it but it is fairly long and we only have limited time so perhaps you could cover the main points rather than reading it all.

Mr Robertson—Sure, I was going to say that I have no axe to grind except to argue that policymakers across the world were right to use all available measures to limit the risk of another Great Depression. I am happy to take questions. I have a handout which illustrates some of the points I was going to discuss.

CHAIR—I did not want to totally inhibit you, Mr Robertson.

Mr Robertson—I am not inhibited.

CHAIR—You are welcome to continue to make comments. I was just saying that if you want to run through your statement in overview and deal with the main points then that would be helpful to the senators.

Mr Robertson—As you are aware, following the collapse of Lehman Brothers in mid-September last year global output, industrial production and trade cratered as almost never before. There were a great number of serious observers who worried that the global economy was at risk of falling into a second Great Depression. The guts of my observation is that policymakers across the world, in using all available measures, did the right thing in limiting that damage, and happily we now have a global economy that has stabilised somewhat and a much brighter economic outlook than we might have had if nothing had been done.

In Australia the situation is that this recession looks to be smaller than the previous two recessions. Whereas the US has had its biggest recession since the 1930s, that is not true in Australia. In Australia we have had a recession that is smaller than the previous two. Nevertheless, we have a situation where full-time employment has fallen three per cent from its peak and aggregate hours worked has fallen 3½ per cent from its peak. That is a dismal story for those who have lost hours and so lost some economic comfort.

You have heard today from the Governor of the Reserve Bank. There is much discussion about when the Reserve Bank is going to start hiking up rates. Governor Stevens has made it very clear on several occasions that he is looking for the earliest available opportunity—the earliest reasonable opportunity—to start removing the emergency setting on interest rates. To this point the Reserve Bank Board has made a judgement that the policy settings are appropriate. So as the committee forms judgements about whether or not to do something with the stimulus package, that has been discussed and is in the process of being implemented. The Reserve Bank so far has been able to move in little quarter-percentage-point lots. So far it has done nothing in terms of tightening. I think that when the board meets next week it will leave the policy setting unchanged at the sort of emergency and generational low of three per cent.

I have a lot of charts but basically the story is that the global economy cratered as almost never before and policymakers moved sharply in the right direction. The US economy is basically still struggling. They have lost five per cent of employment so far and unemployment looks like it is going to hit 10 per cent in the next several months, and it is probably going to stay in double digits for an extended period. So that is very painful.

Australia is in a much better situation, in part because of good luck but also because of good management. We have had a forceful and timely easing of fiscal and monetary policy. We have had a bounce-back from China. In 2009 China has gone from bust to boom in about 10 minutes. That has been extremely helpful in terms of stabilising demand for exports and stabilising global commodity prices—and, indeed, forcing them higher. And we have rapid population growth. That is on top of what you already know about the Australian banking system being in much better shape than most other banking systems. So I think good management and good luck have been very important. I have charts showing aggregate hours worked falling in both the US economy and the Australian economy, and yet our household sector has remained in much better shape despite the potential loss of income from a lower number of hours worked.

I was also going to make the point that the \$42 billion estimated cost of the package is a four-year costing. It is a big number but all these things need to be put into perspective. Federal revenues these days are around \$300 billion per annum so \$42 billion over four years is less than four per cent of total revenue over that period. Similarly nominal GDP in Australia is something like \$1.2 trillion per annum so the \$42 billion cost of the package over four years is about one per cent of GDP. So they are big numbers but I think they are numbers that are manageable in the context of what we have been dealing with, which is the worst global economic backdrop in generations.

In terms of other things we have seen, \$42 billion is a big number but we have seen big numbers in our budget in recent years. The upside surprises in revenue in the year to May 2006 and May 2007 were in the order of \$50 billion or \$60 billion and we had tax cuts announced in both May 2006 and May 2007 of \$30 billion to \$40 billion so we have seen these sorts of

numbers before. In fact there were non-tax initiatives on top of the tax initiatives in 2006 and 2007 that totalled \$38 billion. So we have had several other developments in recent years that are of the same order as the February stimulus package.

No-one wants to have a package that hits at exactly the wrong time and causes the economy to go into overdrive, to overheat and forces the Reserve Bank to hike rates aggressively. Many people have observed that the maximum fiscal impact of this package is in 2009 and it naturally scales back in the next year or two after that. So I do not see any great risk to interest rates from the package except to say that if the economy is stronger because of the package then that will naturally put some upward pressure on interest rates. We have an emergency set of interest rates—the lowest level any of us has ever seen—because the economy was in such dire straits. To the extent that the fiscal package helped it not to be in dire straits then interest rates might be higher than they would otherwise be. But in general it is just a fact that in all circumstances good news on the economy is bad news for interest rates. To the extent that the Australian economy does well and unemployment falls and wage and price pressures build, the Reserve Bank is biased towards tightening.

In the current situation, however, we have seen full-time employment edge lower, aggregate hours worked edge lower and wage and price pressures decelerate, so at this stage the package has not exactly set the world on fire in Australia. The monetary policy measures, the fiscal policy measures and the government guarantees of the core of the financial system were all broadly in line with sorts of things that have happened elsewhere, but I think our policymakers in general have done a better job than policymakers in most other places. At the same time we have had the wonderful bonanza of China rebounding from bust to boom, and that has been fabulous in terms of supporting our economy.

CHAIR—Thanks. Your charts and your paper are very interesting. Would you like to table them as a submission so we can include them in the documents of this inquiry?

Mr Robertson—That would be fine. I noticed I have an error in chart 12. At the top it should read: index equals 100 in July 2009.

CHAIR—The committee accepts your submission as evidence. It will be posted on the internet, if you are happy with that.

Mr Robertson—I am.

CHAIR—Thank you very much. I am quite interested in what you said about China and the Chinese recovery having a major impact on the Australian economy. Had that not occurred, how effective do you think the stimulus would have been in managing this crisis for Australia?

Mr Robertson—There would just be one good thing fewer helping us. I see all these various measures—the fiscal policy measures, the monetary policy measures and China turning up so strongly—as reinforcing the trend to better economic news.

CHAIR—Without the China factor, what other measures might the government have needed to take?

Mr Robertson—Macroeconomics is about stabilising economies. We saw the Reserve Bank take the cash rate down from 7¼ to six to five to four per cent. Then, to the extent it was not getting the stabilising effect it liked, it cut it to three per cent and was open-minded about cutting it further. In fact markets in March, in the darkest days of the financial panic, thought the Reserve Bank would go to two per cent. So I think the answer really is: more forceful policy measures. To the extent that policy measures are not working, most policymakers would think more forceful measures are appropriate.

CHAIR—Thank you very much.

Senator HURLEY—In terms of your overall submission, the package was designed with an immediate effect, an intermediate effect, which we are in now, and a long-term effect. You alluded to it in your opening statements, but has that design provided an effective way through what was happening in global terms for Australia?

Mr Robertson—In terms of the formulation, there may not have been a more sensible package. It is an unprecedented episode, but I am not sure there has been a package like this one. There was the cash splash designed to support the household sector ASAP. Then there was the idea of supporting economic activity more generally. Someone thought of building in pretty well every school in Australia, so there will presumably be nearly 10,000 buildings. That is obviously designed to generate extra economic activity in every community in the country. Then there are some of the longer term projects. To me that make sense. Other economists can speak for themselves, but I think most financial market economists, many of whom grew up in the Reserve Bank and Treasury, would think the package was reasonably well structured given the economic circumstances.

Senator HURLEY—Submissions at one extreme end have suggested that there was no need for any economic stimulus at all. But others have been saying that, given that the economy has weathered the storm better than expected, we should pull back on some of that stimulus spending. You have indicated with unemployment figures and so on in one of your charts that we are still not at the stage where you could say: let's sharply pull back on the remainder of the stimulus package.

Mr Robertson—I think it is hard to argue right now that the economy is too strong and therefore we must stop it from growing as fast, which is effectively what pulling back would involve. I did hear some of the discussion last Monday in Canberra, and one of the things I think some of the other presenters were missing was a sense of how close the global economy and financial system were to catastrophic collapse. I really do believe that there were a few days there where it was so hairy that it could have gone the other way. That is not just my view; if you chase down some of the key policymakers across the globe I think you will find they have a strong sense that it was a very close call.

So, as I said, I think that policymakers everywhere did the right thing. Their thinking was pretty simple: they set out to do the exact opposite of what they perceived policymakers did in the 1930s. They deliberately cut interest rates to generational lows. Rather than tightening monetary policy—as happened in the US and as happened, via the gold standard, across the world in the 1930s—central bankers across the world cut interest rates to generational lows. In the 1930s the US treasury secretary oversaw a tightening of fiscal policy and cut government

spending. This time, governments across the world made a judgement that fiscal policy should be eased aggressively rather than tightened. Instead of watching the banking systems fall apart, central banks and governments across the world basically guaranteed the core of their systems. All of those things were basically the exact opposite, or at least policymakers perceived they were, of what happened in the 1930s. They have probably been surprised at how effective the combination of those policies has been, to the extent that the global economy has stabilised and there is some sort of global recovery underway. It may have all happened by itself—I doubt it. I think policymakers around the world did the right thing, and hopefully that good news will continue.

Senator HURLEY—I found the chart with the comparison of US and Australian housing prices on page 21 of your submission very interesting. Australian house prices, as others have noted, are on an upward trend now. There was a small downward movement and they are now back up, which in itself might be a bit of a cause for worry in terms of them perhaps going too high. But, in the next chart, you have indicated that there is no overbuild occurring in Australian housing, so the demand is still there. Then, in the chart on page 23, you show what this committee has heard several times anecdotally—that housing credit is quite difficult to get for many people and that there is no loose lending to people who cannot afford to pay a loan back. Would you like to comment on that?

Mr Robertson—I think it is a good thing that Australian house prices have gone up rather than cratering, as they did in the US and the UK, in that it was the collapse of house prices that helped collapse the US and the UK economies. But I do not think there is any mystery about what happened. Through last year the Reserve Bank hiked rates aggressively when it was trying to slow the economy. One of the obvious places that hurt is the housing market. So, as the Reserve Bank oversaw a move up in mortgage rates from about eight per cent to 9½ per cent, house prices started to fall, and they fell further when the equity market started to collapse. But, within months of the Reserve Bank starting to cut interest rates aggressively, with mortgage rates coming down from nine-point-something to eight, seven, six and then five-point-something per cent, the housing market stabilised and started moving up.

As you say, one of the standout features of the Australian housing market is the fact that for the past two decades we have typically built about 150,000 new homes per annum. We have wobbled around a flat trend of around 150,000 new homes, notwithstanding that population growth and immigration have had a massive structural increase. I think the figures last week showed that Australian net immigration, net new people arriving, was something like 278,000 in the year to March, which is multiples of the level back in, say, the early 1990s. So there has been a structural increase in net immigration in Australia and no-one has bothered to build extra houses for the immigrants to live in. There is no overbuild in Australia as there was in the US, and that is one of the things that has supported house prices at a time when I think most people wanted house prices supported.

In terms of credit growth, it is the case that in the previous booms in Australia, as shown in the chart on page 23, credit growth was up there in the 20 to 25 per cent per annum range. Right now, housing credit growth is about seven per cent. So when people start talking about bubbles and booms, they probably need to be dragged back down to earth with the observation that housing credit growth is about seven per cent. It has been enough to support the Australian housing market. In fact, house prices have risen. I think, in part, that is because there is limited

stock available. There are a lot of people who want to buy a house to live in. The four per cent drop in mortgage rates has really shifted the rent or buy decision for people who were renting and had not previously owned a house. Suddenly you can fund a house at a bit over five per cent when the rental yield might be somewhere near five per cent as well. So the rent or buy decision has been shifted dramatically by the sharp fall in interest rates, and that is one of the reasons why house prices have managed to go up rather than come down.

Senator HURLEY—I think that chart illustrates that point clearly in regard to housing. What about in general? With interest rates at the relatively low level that they are, do you think that there is any danger of an asset bubble in any other area than housing?

Mr Robertson—One of the things that happened was that the whole world discovered that asset prices can fall sharply as well as rise. People learnt over time that the way to wealth was to gear up to borrow a lot of money and to buy assets. For example, if house prices are going up by 10 per cent a year, if you own three you make a lot more money than if you own one. Equity prices have been trending up for two decades and I think it became a very common strategy to gear up and hope for the best. That worked well for a long time while asset prices were rising, and in the past couple of years lots of investors who really did not have a clue that equity prices could halve basically had their heads handed to them. It turns out that they had no risk management. They owned shares because they thought they would go up and then they sat there and owned shares as they halved in price.

I think that a lot of people have been burnt by the experience of recent years and there is a lot more risk aversion around now. There is a lot more caution and a lot more debt aversion. There is almost a self-induced wariness. It is easy to have a bubble when no-one has been burnt for a long time. We have just had thousands, even maybe millions, of investors across the globe who have been burnt as almost never before. I think everyone is a bit more cautious now, so it will be struggle to get a bubble going anywhere. In any case, the Reserve Bank has made it clear that it keeps an eye on asset prices to the extent that asset prices are going up rapidly. It will see that as something that will fuel demand. It certainly would make the observation that asset prices are moving ever upwards. Eventually it will make the observation that the emergency has passed and it is time for rates to move higher.

Senator HURLEY—Thank you, Mr Robertson.

Senator XENOPHON—Mr Robertson, in your submission you said that, given the brightening of the economic outlook since February, it makes sense now to put greater weight on value for money from the many thousands of projects underway and less weight on sheer haste to support aggregate demand. There are two parts to that. Firstly, are you saying that the quality of the spend ought to be different, not just the speed at which it is implemented? Secondly, how would you finetune things so that you make sure that you do get that value for money?

Mr Robertson—I guess I would leave that to the experts, but obviously taxpayers will not be happy if money is wasted, so to the extent there are reports that money is obviously being wasted—and I do not know if those reports are right or wrong—I think it would be sensible for the government or the departments to follow that up aggressively and make sure that money is not wasted. There was an immediate need for a lot of help for the economy and now that things have stabilised the economy is still weak but the situation is not as serious as it was six months

ago, so I think there is more room for running a sharper pencil over some of the costs. There is room for more time to take in whether the particular building in a public school is the right one to respond to something.

Senator XENOPHON—Or whether to build it at all?

Mr Robertson—Again, that is a judgment that the government needs to make. But I think the government has made it clear that it still thinks the economy needs support, so I do not expect there will be any wholesale scaling back of the planned building in most schools. In my mind I am more thoughtful of the thinking of some of the reports out there that the wrong buildings are getting built. If that is the case, then there is a bit more time and a bit more room now to investigate those issues and be sure that there is value for money and whatever building ultimately gets built. And on the larger projects there is room, I guess, for another look at the cost-benefit of it. I assume that the government thinks that all these things always made sense—that they would get value for money. To the extent that that is happening, I think that is fine. I think the economy at this stage remains sufficiently weak that it needs quite a bit of help. At this stage the Reserve Bank seems to agree and it still has the policy rate at three per cent.

Senator XENOPHON—Thank you.

Senator FIELDING—My question was on that point and I want to take that a bit further. You do say here that the economy is still weak but you do say that the economic outlook is brightening and the outlook since February has become more positive. There were reports in the paper today about still spending the same amount but at a slower rate to make sure that the quality is even better. Do you think there is an argument for that? Is that what you are really saying?

Mr Robertson—I think there was a need for immediate action previously and now that to some extent the economy is doing better than we almost could have hoped I think there is room. I think that was an Alan Mitchell piece in the *Financial Review* today. Yes, there is room just to ensure that the money is being spent well. In terms of paring back and cancelling projects, that is something that would benefit the budget line but at the same time would limit the strength of the economy down the track. So if you thought the economy was going to be too strong, then you might think cutting back is a good idea. If you thought the economy was going to be weak, you would think that it wasn't such a good idea.

Senator FIELDING—I just want to touch base on that chart 'Unlike US, no overbuild in Oz housing'. I do not know whether you have had a look at this longer term. Have you seen such a large gap in the last 30 years? That seems like a large rise in unmet demand. There are a lot of people who are going to want housing and there is a lack of building going on. I think that is more good fortune than good management. I do not believe that it is deliberate that we would have so much shortage of stock. Are there alarm bells going off for you? I know it keeps the price of housing high, which is an extra benefit for those who have got a house, but there are a lot of Australians that are going to be short for a long, long time, aren't there?

Mr Robertson—A lot of new Australians, too, in the sense that we have the highest level of immigration in our history by quite some way. If I am right, the 278,000 figure is about 20 per cent higher than in any earlier year and it is multiples more than the 50,000 to 100,000 that was

typical in earlier decades. As I said, the issue is that immigration has stepped up to a high level and nothing much new has happened on the home-building front. That, I think, is one of the things that Governor Stevens has said in the past, where he has observed that it would be a pity if the main thing we got out of the low interest rate experienced was higher house prices rather than more houses. One of the things holding the show back right now, obviously, is that we are still in the middle of a global credit crunch the likes of which the world has never seen—or at least not since the thirties. Credit is difficult to obtain, apparently, particularly for those companies that are trying to build apartment blocks. That is one of the issues right now.

Senator FIELDING—Are there any other economic impacts going forward other than keeping the price of housing high? Is there any flow-on effect? Do you see any problems with that for Australia going forward if we kept it at that level? It is quite a big gap.

Mr Robertson—No, that is it, basically. Everyday people will struggle to buy a home somewhere near where they want to live. Obviously, the further you go away from here—or the centre of all of our capitals—the cheaper housing gets. Something like 60 per cent of Australians seem to want to live close to the centre of our coastal capitals. There are not the extra houses being built in our coastal capitals and there are more and more people competing aggressively to buy the best located pieces of land.

Senator BOB BROWN—After a period of corporate greed, in which Macquarie Bank was no shrinking violet, we have got, due to the private sector's mismanagement, an injection of \$42 billion of taxpayers' money to help the economy get out of that mess just in this country. Here we have a peon of praise from Macquarie Bank for that government rescue, I presume under the rubric of 'Have your profits kept in the public arena but socialise your losses.' In view of the support you have for the stimulus package helping the private sector get out of the mess of its own making, why should the government not move in on CEOs' salaries? I cite Mr Alan Moss's severance package less than 24 months ago by the Macquarie Bank of some \$27 million. If you take the whole package into account, it is \$80 million. Why should the government not likewise move in on that sort of corporate excess to make sure that the public isn't left to bail out the private sector with billions of investment in the future?

Mr Robertson—I would like to think that I would give exactly the same presentation to you if I had, say, been working out of a university in Melbourne or elsewhere. As to whether the incentive structures in the financial system across the world were wrong, where the incentive might have been to take on excessive risk, to gear up excessively, on the prospect of what you might call 'excessive' remuneration, I think the governments of the world should look hard at that. If governments made a judgment that that was the process that drove the boom that ultimately turned to bust, then governments should look at it and governments should find a way to limit excessive remuneration, excessive gearing or both.

Senator BOB BROWN—Would you support the Greens move to put a cap of \$5 million on annual remuneration by CEOs in Australia? I am inviting Mr Robertson to back our policy here.

Mr Robertson—I do not know whether I would support it, but I would support your investigation along exactly those sorts of lines, because I think it is widely agreed among observers that it was the financial system that was excessively geared—not so much the households or the businesses across the world. I think I have seen a presentation by former

Reserve Bank Governor Macfarlane who thought the surprise in this episode was finding out the extent to which the finance system across the globe was much more highly geared than many policymakers realised, and it was the savage move to risk aversion that prompted the downward tumble in asset prices and ultimately collapsed the global economy. I think that is exactly what the governments of the world should be investigating.

Senator BOB BROWN—You are warming me up to your response, here, Mr Robertson. We are still in a period of global recession, although this country is doing better, but we are putting \$42 billion of taxpayer's money, which, I submit, could have gone, without a recession, into some very worthy social pursuits if we were going to spend it. But we are still seeing CEOs in this country—Macquarie Bank has been chided, I think, into—

CHAIR—Senator Brown, I do not think that is related to the purpose of this inquiry.

Senator BOB BROWN—It is very much related to the stimulus package and the action the government has taken on that. Do you believe the government should be looking at a means of preventing these sorts of returns we are seeing at the moment, where CEOs are still getting millions, or and in some cases more than \$10 million, in this period of economic downturn in Australia?

Mr Robertson—I would not pretend that my expertise spans all things, but I think, as I said, that governments around the world need to look carefully at the extent to which the prospect of high and sometimes extraordinary levels of remuneration fuelled the excessive risk taking and gearing that ultimately turned around sharply and dragged the economy down. I certainly would not object to you limiting my salary to \$5 million but, as to what the right number is for a well-performing CEO in any part of the Australian economy, I do not know the answer.

Senator BOB BROWN—I think it is a bit excessive—not for you. I think some limit needs to be put on it. I thank you very much, because I will feel a little more confident, even despite the government's repeated rebuffing of it, next time the Greens put to the Senate a motion to clip the wings of the more greedy CEOs and limit their payouts.

Senator COONAN—Mr Robertson, I just wanted to take you, if you would, to some market aspects of increased government borrowings, because that is an area where you have been in the space for quite a while. Does government borrowing have an impact on domestic interest rates, either in the short term through its influence on the cash rate or in the long term?

Mr Robertson—I tend to think of interest rates in Australia, as elsewhere, swinging around mainly on the changes in the outlook for the economy, particularly the outlook for inflation. We know that across the world central banks are determined to keep inflation low, so anything that prompts stronger growth for a sustained period ultimately forces interest rates higher. For example, you can see in the chart on page 19 the expectations of the Reserve Bank's cash rate. At the peak of pessimism in early March, the market had formed a view that the Reserve Bank would be forced to cut further. The Reserve Bank had cut it to 3¼ per cent in February, and it was felt that the likelihood was that it would take rates down by a further full percentage point. When equity markets started to bounce, as I think is shown in one of the early charts, and credit conditions seemed to ease up a bit and we got some brighter news on some of the global economic indicators, we saw markets gradually price out that easing. Subsequently, prodded

somewhat by the Reserve Bank, they started to focus on the idea that interest rates might go up here at some point. If you look at the charts for our interest rates versus interest rates around the world, they are very highly correlated in this episode. Basically, bad news on the economy was good news in terms of lower rates and good news on the economy saw rates move higher.

Everything is relative. Most of the rest of the world have borrowed or are in the process of borrowing much more aggressively than the Australian government, so I think the influence of our efforts here is relatively small. In any case, there is low inflation everywhere. In the US—which is still the biggest economy in the world—because unemployment is moving to double digits and there is massive excess capacity, they have what is called an output gap. Their output gap is way bigger than anything seen in generations. I think there is going to be ongoing downward pressure on their wages growth and their core inflation. So the base for world bond yields is being suppressed by the fact that the biggest economy is still in dire straits.

Senator COONAN—How difficult is it for Australian borrowers to raise money offshore? Is there a limit to the Australian dollar exposure that offshore investors are willing to take on?

Mr Robertson—Again, I would not really claim to be an expert in bond raising. We heard the AOFM earlier. I think Australia's impressive outperformance over the past year or two leaves us in good shape to borrow. There was a discussion earlier: 'What's a AAA rating and how come the US has still got one?' It is a good point. In terms of funding fiscal deficits, we are borrowing less and our economy is in much better shape. Our fiscal position is much stronger, so I assume that we will have much less trouble. If there is going to be trouble down the track, it will not hit us first. We are at this present time perceived as a bit of a safe harbour, in part because the world has decided that China is barely going to miss a beat for the next decade.

Senator COONAN—Can you comment on the crowding out issue. If the demand for Australian dollar assets is fully met by government issues, does it mean that there will be less money available for private borrowers, thereby giving rise to the crowding out argument that has been well and truly canvassed over the last few months?

Mr Robertson—I think that is possible, but I think the numbers involved are relatively small. We are talking about four per cent of government revenue over the next four years. I think the numbers are relatively small versus the potential for trouble. If our house prices and our economy had crated in the way that the US economy crated, you could ask stronger questions about that, but I really think the damage here in terms of the budget position is relatively small. So it is a struggle to bang the table about how disastrous it might be in terms of our ability to fund it.

Senator COONAN—This is something that the AOFM may or may not be able to frankly comment about, but do you know how easy it is to market Australian dollar assets overseas?

Mr Robertson—I literally do not know. I had the awkward situation a bit over a year ago with my latest marketing effort offshore. We were going to run a conference called 'Australian RMBS'—Australian residential mortgage backed securities—'the Pick of the Bunch'. That seminar went ahead in London on the day that Lehman's collapsed, so I have not been required to go offshore subsequently.

Senator HURLEY—It was your fault!

Mr Robertson—It was not my fault, but I really do not have any good information for you.

Senator COONAN—You are not able to comment on it. Thank you.

Senator CAMERON—One of the constant political points that has been made through this inquiry is that the government should not have taken any action until econometric modelling had been done in relation to the package. Do you have a point of view on that?

Mr Robertson—Only the same one I have tried to express through this session: I think the governments and central banks of the world did the right thing by acting as quickly and as forcefully as they could. I genuinely do believe the world was on the brink of a catastrophic economic and financial meltdown. I think that policymakers everywhere moved sharply in the right direction. That is about the extent of my observation. I think there is room to quibble about whether the right amount of money was spent or whether the projects were exactly right. There is room for debate there, but I personally think there is no room to debate what is a fact: central banks and governments, by taking interest rates to generational lows, by boosting government spending and by guaranteeing the core of the financial system, did nip Great Depression 2 in the bud.

Senator CAMERON—Mario Draghi is the Chairman of the Financial Stability Board—

Mr Robertson—In Britain?

Senator CAMERON—I think it is the Financial Stability Board of the G20. He argued that one of the problems is that we have to ‘break the negative feedback loop between the financial system and the real economy’. Are you aware of that statement? Have you any comment about what that negative feedback loop is?

Mr Robertson—I am not aware of the exact statement, but I am aware of the issue. Basically, when the global panic was at its height, falling share prices and falling house prices in the US and the UK fuelled growing pessimism. So there was more hunkering down and it became a deeper recession. Everything was working in the wrong direction. To some extent, that adverse feedback loop was short circuited by the aggressive policy response. Even the people who argue that somehow the cash splash in Australia did not actually prompt extra spending should recognise that in fact confidence is everything. Times were genuinely bleak. All the measures that help people think that there will be brighter times ahead—including, for example, Governor Stevens wandering out regularly and saying that the long-term outlook is bright—were really important in terms of stabilising confidence and stopping the place from cratering. In that sense, policymakers caught the economy before it hit the ground. There was lots of good luck. China’s performance is an extraordinarily helpful thing for us in Australia. But policymakers moved sharply in the right direction and in this case short circuited that adverse feedback loop that you have described.

Senator CAMERON—Australia is participating in a global response to the global financial crisis. It is not as if we are doing something on our own. China was part of that response as well. Is that correct?

Mr Robertson—Yes. I guess that I consider all of these policy measures to be more correlated than coordinated. They are correlated in the sense that the whole world was dealing with an extraordinary financial panic and a sharp move towards deep recession, and so the whole world's policymakers were focused on the same issues, such as how they could stabilise the situation. Everyone did similar things because everyone has essentially the same policy tools.

In China, they seemed to do it bigger and better on the fiscal front than anyone—at least to this point. I do not know the full details of it, but I understand that they had a massive package. The data—I guess to the extent that you believe it—speaks for itself. China, which has grown 10 per cent per annum on average for the past three decades basically had a sudden stop in the fourth quarter with almost no GDP growth. Then the packages were pumped and the Chinese economy got going again in the first quarter. In the second quarter, it recorded four per cent growth. Four per cent annualised is something like 15, 16 or 17 per cent. So in the second quarter the Chinese economy grew at one-and-a-half times its standard pace. As I said earlier, that has been extremely helpful in terms of stabilising our exports and helping world commodity prices bounce back. As you know, the Reserve Bank has documented that Australian exports have actually risen over the past six to nine months, whereas across the world they were at the worst point down something like 10, 20 or 30 per cent.

Senator CAMERON—We have had three academic economists say that a move to Keynesian economic stimulus was a great catastrophe. One of them put it in those terms but others argued that there should no intervention in the economy of a Keynesian nature. Why are these academic economists giving us this line of argument when Treasury, the Reserve Bank and economists like you have a different point of view? Is this just the age old difference or is there something that we have not picked up?

Mr Robertson—Everyone has an opinion. Your opinion in part depends on where you have been and what you have seen. I do not exactly why those academics—

Senator CAMERON—So if they have only seen the RMIT lecture rooms it might be a problem.

Mr Robertson—I saw some of that discussion and I found the point of view to be particularly unconvincing. That is about it.

Senator RYAN—I want to explore further the issue of what you referred to as the 'catastrophic collapse' in one answer and then the 'potential catastrophic economic and financial meltdown' in another answer. Please correct me if I am wrong, but this was about where you saw the global economy post Lehman Brothers. Wouldn't it be fair to say that the actions by which that meltdown was avoided were mainly the actions of the central banks through providing liquidity and wholesale funding guarantees? Weren't the systemic measures that they took that ensured that the banking system kept functioning more important than the cash splashes in December and February? The catastrophic element in this was more about a meltdown or a freezing of the financial system, rather than the reduction in private demand, wasn't it?

Mr Robertson—The government's of the world guaranteeing the core of the financial system was critical. Beyond that, it is hard to decide which bits of the policy response were the most effective or the most powerful. I think that policymakers had various tools to employ. It was

right that each policymaker who had a tool used it aggressively in an expansionary direction. As I said, there is lots of room to discuss the nitty-gritty. But I think that policymakers in most places, including Australia, moved very smartly in the right direction. Maybe it is just good luck that we are sitting here today with a much brighter economic outlook than we might have been, but I do think that policy was very helpful. I agree that the guaranteeing of the core of the financial system across most economies was maybe the single most important thing that helped kill the panic and limit that systemic meltdown.

Senator RYAN—You mentioned more broadly that the level of consumer confidence is particularly important. There was a dramatic shift in commentary about the state of the economy between the first half and the second half of last year; from the point of the long-forgotten inflation genie to the pending end of the economic world. Doesn't undertaking systemic shoring up of the core of the financial system, to use your words, and expansionary fiscal policy stand in contrast to at the same time effectively talking down the economy, which can have a dramatic effect on damaging confidence?

Mr Robertson—The collapse of Lehman Brothers basically collapsed the global economy. To the extent that you had to observe that things had got very bleak to put the policies in place to try and stabilise the situation, I am not sure that—

Senator RYAN—Let me put it another way, then. If the government is talking about the positive aspects of the economy versus doom and gloom, does that have an impact on consumer confidence in your view? Does it have an impact that is akin to the collapse of Lehman Brothers?

Mr Robertson—To the extent that the upbeat commentary is credible, then it would reinforce people's perceptions that things are not that bad. Confidence is one thing, but the thing that stands out in this episode versus earlier episodes is simply the fact that job losses have not happened on anything like the same scale. Full-time employment is down three per cent, not five or seven, as it was in the previous two recessions.

Senator RYAN—I appreciate that. I was just trying to compare the language of the government and senior government officials in this crisis with that in the aftermath of, say, the Asian financial crisis, which Australia bore readily well, the tech induced recession in the United States earlier this decade. In those cases, the governments tended to focus on trying to maintain consumer confidence. In the second half of last year, however, the government spoke of a great deal of doom and gloom. Do you think that that has had any impact on consumer confidence?

Mr Robertson—I would observe that the whole world was cratering as almost never before. I like to say upbeat things. I am not a born pessimist. But I know that I was writing stuff that was headlined, 'The bleakest economic outlook in decades.' I think that that was a fact at the time. I guess that I am impressed in retrospect at the extent to which Governor Stevens was able to walk out and say upbeat things based on the long-term outlook, because in the short term I was worried that things were going to get increasingly dire. One of the lessons from this episode is that very few people are very good at forecasting anything that matters and most forecasts tend to move in line with the latest data. When things are good, everyone forecasts upbeat things; when things are cratering, they tend to be very pessimistic. In this episode, the people who got it

right by being pessimistic before the world fell apart have tended to be too flatfooted and pessimistic in recent months when things have brightened considerably.

I think that is, in part, because the biggest economy in the world, the US economy, has cratered as almost never before, and many other economies have been dragged down by the biggest economy having its biggest recession since the 1930s. In the Asian crisis that did not happen. Our Asian export partners were in a great deal of trouble but the exchange rate fell a long way and our exports were able to be diverted to a reasonably strongly growing US economy. In this case the Asian economies were cratering; the US economy was cratering; the European economy was cratering—all of them as almost never before. For me, at least, it was a struggle to say upbeat things so I can understand why any policy maker who had to do a commentary on the economy would have struggled to say upbeat things except, ‘We’re going to do what we can to stabilise the system.’

CHAIR—Thank you very much indeed, Mr Robertson. That has all been very good, interesting evidence. Thank you for appearing.

Proceedings suspended from 1.11 pm to 1.41 am

EVANS, Mr Greg, Director, Economics and Industry Policy, Australian Chamber of Commerce and Industry

CHAIR—Welcome. I apologise for the lateness of our start, but we went over time quite substantially with the Governor of the Reserve Bank and have not been able to catch up. I invite you to make an opening statement.

Mr Evans—Thank you, Chair. From the outset of the pronounced decline in economic growth in the second half of 2008 and the impact of the crisis in financial markets at the same time, ACCI has supported the extent and nature of the government response and that of the Reserve Bank of Australia. The broad based slump in economic activity, accompanied by a lack of confidence and certainty in financial markets, posed the greatest economic challenge to policymakers in modern times. Globally linked and integrated markets meant no national economy could bypass the impact of falling demand and the shrinking availability of credit. The presence of strong links between economies was also a major strength. Avoiding the mistakes of the past, a consensus emerged to undertake speedy fiscal stimulus and monetary easing. The Australian government was right to take this path and in fact to act more quickly and decisively than most. While the return to more normal growth levels is still some time off, at the time of the announcement of the December and February stimulus arrangements the economic outlook was deeply concerning and, given this, the scope and scale of stimulus was entirely warranted.

ACCI was a supporter and in fact a contributor to the economic stimulus plan and, on behalf of our membership, proposed and discussed with government the introduction of a general tax break for business in the form of the general business investment allowance. We consider this to be one of the most successful and effective components of the stimulus arrangements. It has certainly assisted motor vehicle sales and provided strong incentives for plant and equipment upgrades across Australian business. We would expect further uptake by small business by the time of its expiry at 31 December 2009.

With the rationale that government spending be provided to promote stimulus in the economy, we considered it should initially be provided to households to promote private spending, and as incentives to business to encourage investment and appropriate infrastructure outlays to help short-term demand and deliver long-term productive capacity improvements. The effect of the stimulus has impacted across the ACCI membership. Support to households has bolstered retail spending, and this evidence has been recorded amongst our retail members and those in the hospitality and restaurant-café sector. The first home owners boost has assisted construction, with school and infrastructure spending assisting a number of members in the non-housing construction sector, including sectors like electrical services and plumbing, who are amongst our membership.

In relation to the implications of these arrangements for the next several budgets and government debt, ACCI remains cautious and supports the view that the budget should remain in balance over the economic cycle. We understand the government approach to achieve this in terms of the work of the automatic stabilisers and limiting growth in government spending. Upon returning to a more normal growth level, we believe that reductions in government

spending should occur to target both waste and inefficiency but also that there should be a review of government programs and a more root-and-branch review of overall outlays.

While the stimulus package has come at a substantial cost to the budget and we will require prudent management to return to balance, the risk in the economy of a more limited fiscal response might have been higher. We do not consider the easing of monetary policy on its own would have been sufficient to avoid a more serious economic slowdown or indeed recession.

Despite improving economic news and improving consumer and business confidence levels, the fundamentals of the economy remain fragile. This is according to both official statistics and the surveys of the ACCI. We expect the labour market to continue to worsen and note the shift from full-time to part-time employment has to some extent masked the severity of the slowdown. Retail trade remains subdued, as does business investment, and credit conditions continue to constrain opportunities for business. Most importantly, international conditions amongst our trading partners remain weak.

In conclusion, we do not believe these are the circumstances where fiscal stimulus should be withdrawn, noting that in any case the design of these arrangements sees a phased wind-down. Nor do we consider premature monetary tightening is warranted, for fear it may choke off early signs of recovery.

Senator BOB BROWN—Thank you. You have said that when cuts in spending come they should target waste and inefficiency in the public sector. What about the private sector?

Mr Evans—In terms of Australian business and how it is operating at the moment, I suppose it has been through a period where there has been a need to look at overall costs and controlling costs and that has been exacerbated by the economic slowdown and the low revenues and low sales that have been recorded by Australian business, both large and small.

Senator BOB BROWN—Notwithstanding that, we are seeing some CEO packages in the many millions of dollars, some in excess of \$10 million, during this period of downturn. Do you agree that the government should also be involved in curbing the excesses of what the Prime Minister calls obscene CEO salaries?

Mr Evans—We probably need to differentiate this debate from what was apparently happening in Wall Street in investment banks, in the banking sector, where chief executives and executives were enjoying very high salaries but at the same time they were then receiving government bailout money. In those circumstances, we certainly think that some community concern about that was appropriate. I am not sure that that is necessarily the situation in Australia. Indeed, amongst our membership, which spans both small and large business, we certainly were not seeing that at the small business sector level, where there are obviously concerns about revenues and deteriorating position. Obviously a lot of small business proprietors were even finding it hard to make ends meet.

Senator BOB BROWN—We have seen one executive from the Commonwealth Bank have a \$9.2 million handshake in recent weeks, and the government has bank guarantees in place of, in the long term, \$100 billion to \$200 billion for the big four banks. What do you think about the

appearance of that for the 100,000-plus people who have lost their jobs due to the economic downturn?

Mr Evans—We are certainly cognisant of community concerns regarding high salaries and how they may be inappropriate, especially where share performance may not reflect remuneration to senior executives. However, we would be cautious about what you could actually do from a policy point of view in terms of imposing restrictions on such salaries. What impact does that have on the calibre of executives or the international marketplace? Will people actually want to work in Australia or will Australian executives seek to leave and work overseas? I think we need to be cautious about how we approach any attempt at regulation in that area.

Senator BOB BROWN—To the point of doing nothing? The government has done nothing through this period, except to put up legislation for shareholders to be able to vet handshakes in certain circumstances.

Mr Evans—We understand there is a Productivity Commission process going on at the moment. We are waiting to see that report and to have the appropriate input. All I would say is that we need to be cautious in that area.

Senator BOB BROWN—It has been mooted in the public arena that taxes will go up in coming years to cover the debt from the stimulus package and to help the government make ends meet. Where do you think that taxation should be levied?

Mr Evans—At the outset, we would have a problem with higher taxes in order to deal with debt and the budget situation. Once you have a period of economic recovery, then it may be appropriate to look at overall levels of government spending and see where appropriate cuts may be made.

Senator BOB BROWN—Where would you be looking to make those cuts?

Mr Evans—We have done a lot of work in this area over a period of time. In fact, several years ago we proposed a broad range of cuts to not only deal with waste and inefficiency but look at programs. I might say that amongst those programs are business programs. We were part of that as well. For example—and perhaps this is getting off the topic slightly—in order to get appropriate results from the Henry taxation review, there is obviously a need for our taxation system to be competitive with our neighbours in Asia, who have very low tax rates, and that more or less implies that there has to be constant vigilance in terms of overall government spending.

Senator BOB BROWN—Our neighbours across the Pacific and in the United States have higher tax rates.

Mr Evans—Yes and no. If you look at overall rates of taxation, they are still probably lower in terms of revenue to GDP.

Senator BOB BROWN—Would you, for example, cut health spending in this country?

Mr Evans—I did not really come equipped to do a line by line analysis of the budget. We think that all areas of government spending necessarily need to be reviewed. There is a root and branch review of the taxation system. We are saying that it is probably not a bad idea to look at expenditure.

Senator BOB BROWN—Thank you.

CHAIR—I have a couple of articles here from the *Financial Review* where you said that interest rates could go up in coming times. Also you made some comments about business confidence and the labour market deteriorating. Could you tell us about your concerns about the impact of higher interest rates which may well fire if government expenditure is maintained at high levels?

Mr Evans—We are concerned about the current nature of the economy and the fragility of the economy. We welcome the fact that there has been more positive news in terms of business and consumer confidence. Those expectations need to be converted into reality. We note that retail sales are still subdued, as is business investment. As I said in my opening remarks, businesses still find it difficult to obtain credit from the banking sector, especially small businesses that have been re-rated, in terms of availability. International conditions are still very difficult. With all of that put together, we think the economy is still weak and we do not think this is the environment in which it would be appropriate to lift interest rates.

CHAIR—So that would be quite a negative impact on our economy at this stage? Given what we have heard today, it is likely that interest rates will go up?

Mr Evans—Ultimately, interest rates will go up.

CHAIR—In the near future, though?

Mr Evans—Yes, but we are not attributing that to the current round of fiscal stimulus being applied by the government. Interest rates will go up as the economy recovers. That is quite separate from anything the government is doing with respect to fiscal stimulus.

Senator HURLEY—I would like to explore that a bit further. I think that Governor Glenn Stevens went into the fact that he sees interest rates are at a very low period and he would like, when appropriate, to have them raised. While not as clear or as definitive as you, I think he did indicate that the stimulus package would not have a significant effect on that interest structure over the period that we are looking at: the forward estimates of the budget. Would you agree with that?

Mr Evans—We believe that the actions of fiscal policy and monetary policy have worked in a complementary fashion. For example, by lowering interest rates you cannot actually deliver benefits that you can through fiscal stimulus. Lowering interest rates does not necessarily lead to a road being built or a school hall being constructed or refurbished. We appreciate that there were different aims associated with both the fiscal response and the monetary response.

Senator HURLEY—I think the design of the package—having the immediate response, then the intermediate response and the long-term response—has been reasonably well received. The

moneys out of the stimulus package that we are now seeing spent are at the intermediate stage. The longer term stage will be infrastructure, which will also presumably help in terms of increasing productivity as the economy recovers.

Mr Evans—Certainly, as we all recall, going into this period economic downturn, one of the issues identified was capacity constraints and how we actually address the issue of our infrastructure. This fiscal stimulus package not only addresses the short term in terms of promoting domestic economy activity with respect to building infrastructure but also delivers those long-term productivity advantages associated with better infrastructure provision.

Senator HURLEY—In the long term, in regard to balancing the budget over the cycle and decreasing government spending, I would point out that we first need to get some measures through the Senate, which has been consistently knocking back any government savings.

Senator XENOPHON—Mr Evans, Mr Robertson from Macquarie Bank said that, given the brighter economic outlook since February, it makes sense now to put greater weight on value for money from the many thousands of projects underway and less weight on sheer haste to support aggregate demand. Is that a general proposition that the chamber supports?

Mr Evans—We understand that this fiscal stimulus package was perhaps unprecedented in modern political times in Australia and there was an urgent need to, so to speak, get the money out the door. In doing that, in large amounts of money, inevitably that is going to lead to some difficulties with respect to administration. We would encourage due process be followed wherever possible. I have certainly read the report of the coordinator who monitors these things and provides for accountability and we think, generally speaking, that the appropriate measures are in place in order to have an appropriate spending of money.

Senator XENOPHON—That was not quite what I was asking in the sense that, given that the fiscal stimulus package was designed because of the significant urgency at the time, seven or eight months down the track the indicators are looking much better. Does that mean we ought to just pause in terms of the quality of that spend, at the very least to ensure that we are maximising taxpayer value for money?

Mr Evans—I do not know that we need to pause. One of the initiatives was the general business investment allowance. That has, if you like, an automatic quality control because obviously business do not want to spend on plant and equipment that they do not need. Those sorts of initiatives are important. As far as we know—and we are obviously not intimately involved in contracts—money was targeted for school refurbishment, for repairs and maintenance and for a number of infrastructure projects with respect to road and rail. We would expect that they would be rolled out in an accountable, transparent and efficient manner. We would hope that was the result.

Senator XENOPHON—Finally, some economic commentators who supported the stimulus are saying that there is a good case for re-examining spending for the out years—in particular, the 15 per cent of spending in this package that is due in 2011-12—if only to help the government achieve its fiscal goals. Is that something that we should be mindful of if there are changing economic circumstances in the next 12 to 18 months?

Mr Evans—I think, irrespective of where we go from here, the government have nominated particular projects where they want to spend money and, apart from anything, they will sooner or later be entering into contractual obligations. Certainly where that happens, that expenditure should proceed.

Senator XENOPHON—Even for 2011-12, if they have not been locked in yet?

Mr Evans—I do not know exactly what the contractual situation will be, but some of our members are involved in the pre-feasibility engineering studies for these projects. A lot of that expenditure will be locked in.

Senator XENOPHON—Thank you.

Senator RYAN—We heard earlier from the Reserve Bank Governor that the Reserve Bank takes fiscal policy as a given, that monetary policy is set in that environment and that, quite rightly, that is not a matter for the Reserve Bank. We also heard that, if there were \$20 billion to \$30 billion less over the forward estimates in government spending, that would lead to lower pressure on interest rates as they resumed their cycle to a more normal setting from the low settings we have now. That could be reflected in two ways, one of which would be a slower increase in interest rates back to a neutral setting. The other would potentially also be a lower setting overall. Would it concern you or your membership if the remaining part of the fiscal stimulus were to actually lead to interest rates at levels higher than otherwise would be the case or to a more rapid increase in interest rates? Should the stimulus package be reconsidered or should the remaining funds in the stimulus package be reconsidered?

Mr Evans—I am not sure that we actually accept the fundamental premise that suddenly the economy is in great shape and there is no need for this fiscal stimulus package. We believe there is an ongoing need for both the fiscal measures and also the continuing, more relaxed stance of monetary policy. We do not think the circumstances exist where you would want to wind back any further. As to what might happen in 12 months, we cannot speculate.

Senator RYAN—The point, Mr Evans, was that a fiscal environment has an impact on the monetary policy settings undertaken by the Reserve Bank. If we see a fiscal policy that is looser than otherwise would be the case, there will be more pressure on monetary policy and therefore a risk of a more rapid increase in interest rates or a higher level of interest rates than would be the case without that expansionary fiscal policy. Wouldn't it be of concern to you and your members that interest rates would potentially be higher than otherwise would be the case, given that the economy may well be doing better now than was forecast when this package came in?

Mr Evans—I am not sure about now, but what you say is right from a theoretical point of view. Unfortunately, the economy does not operate in a vacuum and we see at the moment that the complementary roles of both fiscal and monetary policy are appropriate. As I indicated, we believe that there are avenues where fiscal policy has filled the gap where monetary policy would not have worked—that is, in promoting consumer confidence and in assisting certain sectors of our membership, such as in the building sector and in retail trade. We believe overall the current mix is appropriate. We do not think the circumstances have changed enough. We do not believe that the economy has grown more strongly than we would have thought and therefore provides the rationale to wind back those stimulus arrangements.

Senator RYAN—But, given that the Reserve Bank acts independently and sets interest rates in a given fiscal environment, the point I am trying to get to here is that one cannot always have their cake and eat it too—that is, have the fiscal package, as it is currently structured, and interest rates as they are currently, given that, as has been stated by numerous witnesses, they are on an upward trajectory. It does not concern you in any way that the current fiscal settings might lead to that upward trajectory being higher or faster than would otherwise be the case?

Mr Evans—I think within the fiscal stimulus arrangements proposed by the government there is an inbuilt winding down in any case. For example, the household spending initiatives are gone; the first home owners boost is being wound down from the end of this month; and the investment allowance proposals for large business ended on 30 June and for small business will end at 31 December. So we see that gradual winding down of the fiscal arrangements anyway, and we think that phasing is appropriate.

Senator RYAN—My question, I suppose, Mr Evans, is taking that winding down into account, with between \$20 billion and \$30 billion of this stimulus remaining. If that \$20 billion or \$30 billion is going to have an impact on interest rates—which is what we heard this morning—that does not concern you or your members?

Mr Evans—I do not know that I am accepting that premise. In a theoretical sense you are correct, but I think the economy is still of sufficient weakness that that is not potentially an issue at the moment.

Senator RYAN—Well, it is a theoretical premise that the Governor of the Reserve Bank accepted.

Senator HURLEY—I would not put it like that exactly. I think he specifically rejected it.

Senator RYAN—We can look at the transcript, Senator Hurley.

CHAIR—I will.

Mr Evans—Unfortunately, I did not hear the governor.

Senator CAMERON—Mr Evans, we had evidence from three academic economists last week. One of those economists, in response to a question I put to them about the ACCI's comments about not removing the stimulus too quickly, said that businesses are getting money from the government for nothing and went on to say that businesses were acting in their own best interests. What are your comments on that sort of response from these academic economists?

Mr Evans—Firstly, I think that is very unfair. We are actually approaching this from a wider economic perspective on what is good public policy. It so happens, in this instance, that some of the aspects of the stimulus package are actually good for business. Obviously, providing stimulus to households promotes retail spending which in turn helps our members in the retail sector but also helps them to employ people. Business is not some sort of remote sector that does not benefit from specific measures in the stimulus package. There again, also the investment allowance is obviously very helpful to business, but it is helpful in the sense that it provides

upgrading of plant and equipment, which is ultimately good for jobs and growth in the economy. I would reject the notion that we are somehow self-serving in our advocacy of the fiscal stimulus package.

Senator CAMERON—Mr Evans, have you had a chance to have a look at the G20 statement from last night?

Mr Evans—Not in any detail.

Senator CAMERON—I could take you to some of the points for your comments. The G20 statement basically says that we are in a critical period, moving from the recession into some recovery. Do you agree with that sort of proposal?

Mr Evans—Certainly, yes, and we have been on the record as saying that we are a little bit concerned that we are getting a little ahead of ourselves and the recovery story has been a little bit oversold. We are seeing improvement in confidence levels, but they are about expectations rather than necessarily reality, so we want to see some more durable results before we say that we are on the path to much stronger economic growth.

Senator CAMERON—Rory Robertson, from the Macquarie Bank, said that we were facing another Great Depression—it was that close. Do you think that that is a real proposition that was put, and do you agree with the G20 proposition that ‘we confronted the greatest challenge to the world economy in our generation’?

Mr Evans—I think at the time that was quite a reasonable conclusion to draw, especially at the impact of the financial meltdown and the concern that there was in regard to the availability of credit et cetera. That is why we believe that the type and scale of response of the government were appropriate, and I do not think anyone really expected that the Australian economy in particular would exhibit the resilience that it has.

Senator CAMERON—The G20 also says:

A sense of normalcy should not lead to complacency.

And it says:

The process of recovery and repair remains incomplete.

Does the ACCI agree with those propositions?

Mr Evans—We think that there is still some way to go, and that is why we believe it would be premature to withdraw aspects of the stimulus arrangements.

Senator CAMERON—Then obviously that is consistent with the other position that the G20 indicated—that is, to sustain a strong policy response until a durable recovery is secured. How do you believe we should determine when we are in a durable recovery?

Mr Evans—Some of the key indicators of the economy are still weak. We will continue to look at retail trade, where there are some further numbers out this week. We are still concerned about labour force and the labour market. We believe there still will be continued deterioration in the labour market—not to the levels that previous expectations might have been, but we still think there will be. As I said in my opening remarks, we are concerned that there has been quite a large shift from full-time work to part-time work, often on quite an involuntary level, and the impact that that has on people's livelihoods as well as the wider economic impact in terms of things like the durability of consumer spending. We think there are these weaknesses in the economy that need to be monitored as we go ahead.

Senator CAMERON—If the government took the advice that we have received both on a political level and from some economists that we should move out of the stimulus package quickly because it might have some effect on interest rates and be a long-term benefit, what would that do for business confidence at the moment?

Mr Evans—That would certainly have an impact on the level of business confidence, and it would be at odds with what seems to be occurring internationally. Only last week we had discussions with our counterpart, the US Chamber of Commerce, who reported to us difficulties in the American economy, albeit much more difficult than we are currently going through. Their assessment amongst their economists is that they do not want to see any unwinding of the stimulus arrangements with respect to the US economy, and our view mirrors that.

Senator CAMERON—If interest rates did rise, and the evidence we have received from the Reserve Bank is that these are emergency levels of interest rates and that interest rates will rise at some time, would it be better for those interest rates to rise with the third element of the government's financial package—that is, the infrastructure program—in place to continue to support the economy if interest rates did rise?

Mr Evans—We expect interest rates will rise. Our view is that we would hope that does not happen, given where we are in the economic cycle, before mid-2010. Yes, we are concerned that that would potentially snuff out confidence in the economy. Sorry, what was the second part of your question?

Senator CAMERON—Would it be better to continue to have the infrastructure spend that is projected for the major infrastructure project? Should that be stopped?

Mr Evans—We believe that if interest rates do increase over the next six months, for example, it will be on the basis that there has been greater strength in the domestic economy, and we do not think it would be attributable to the fiscal stimulus arrangements that are in place because they are phased in and set in how they are rolled out. If there is an increase in interest rates, it would basically be because the Reserve Bank thinks there is sufficient strength in the economy or particular sectors of the economy that they might be worried about overheating, be it in the housing sector or wherever. We think those are quite separate issues.

CHAIR—As there are no further questions, thank you, Mr Evans, for appearing today.

[2.14 pm]

BURN, Dr Peter, Associate Director, Public Policy, Australian Industry Group

MELVILLE, Mr Anthony, Director, Public Affairs and Government Relations, Australian Industry Group

CHAIR—Welcome. Would you like to make an opening statement?

Dr Burn—Thank you. You would have received our submission by way of a letter from our chief executive, Heather Ridout.

CHAIR—We have.

Dr Burn—Mrs Ridout very much regrets not being able to be here herself; the questions you are addressing are things that very much interest her and are things she feels very strongly about. We have been in close contact with her in the US as we have prepared for this hearing.

I do have some brief opening comments. The Australian Industry Group has unambiguously supported and continues to support the economic stimulus initiatives put in place since October last year. The breakdown of the international financial system and the transmission of its impacts to Australia warranted decisive and timely support to domestic demand and assistance in stemming the sharp erosion of business and consumer confidence. The Ai Group's support for these measures reflected the strength of the reports we were receiving from our members about the sudden fall in activity and the fact that there were no new orders coming through and the difficulties businesses were having in raising capital. They also reflected the distinct deterioration in performance from about August last year in each of the three gauges of activity that we publish monthly: the Ai Group's Australian performance of manufacturing index, our Australian performance of services index and our Australian performance of construction index.

Our assessment of the measures is that, in combination with interest-rate reductions and similar policy actions in other parts of the world, they have made a material difference to economic activity over the past nine months, and, had they not been in place, the economy would have deteriorated much more sharply than it has done. While we see the measures as having made a very positive contribution, we do not think we can say that the economy is out of the woods yet. We remain concerned that a considerable share of the promising signs that we see in the economy are closely related to the stimulus itself rather than to a self-sustained rise in demand. We expect further rises in unemployment and further falls in hours worked, both of which will flow through the economy more broadly, and we remain conscious of the lagged impacts of the falling commodity export prices on company profits, investments and dividends and the impacts that that will also have as they flow through the economy. For these reasons we are very wary of calls for the fiscal measures to be wound back ahead of the inbuilt schedule for their withdrawal. We think that this could undermine the recovery that appears to be taking hold.

As a final point, I would like to emphasise the point we made in our submission—that is, that we do not take lightly the deterioration of budget performance, and nor do we underestimate the

importance of returning the budget to sustainable levels in a timely yet orderly way as the economy recovers. Restoring the budget will require considerable constraint over expenditure over the next several years.

Senator CAMERON—Dr Burn, I remember some years ago Bert Evans, your well-respected chief executive at the time, went on the public record to say he would rather deal with slightly higher interest rates than increasing unemployment. Is that still AiG's view? Would it be better dealing with slightly higher interest rates than massively increasing unemployment?

Dr Burn—Without going into too much detail about that very hypothetical question on slightly higher interest rates versus a massive rise in unemployment, I would say, yes, we would prefer that.

Senator CAMERON—You indicated that the AiG supported the package. The argument has been that the package should be stopped, and yet the argument has also been that the infrastructure projects will not contribute to the productivity growth in the nation. Are you familiar with the major infrastructure projects that are in place?

Dr Burn—We have some familiarity with them, although I must say we are not all that close to all the micro-detail of the packages. But we have some confidence that there will be expansions of capacity that will come from some of the investments in infrastructure, and that—

Senator CAMERON—So that would lead to improved productivity?

Dr Burn—That would increase productivity, yes.

Senator CAMERON—An argument that was put to the committee was that ACCI would say—I think this was the tenor of the response from one of the academic economists—that you are getting money for nothing. Is your support for the package based on you getting something for nothing? I am sure it is a more thought through approach, isn't it?

Dr Burn—It certainly is a much more thought through approach. Certainly, neither the AI Group nor its members are getting money for nothing.

Senator CAMERON—Okay.

Senator XENOPHON—At the end of your submission you say:

... Australia's strong dollar is acting to both put a brake on Australia's export growth potential and constrain overall demand growth.

The Australian dollar has been on a bit of a yoyo. Last year we saw it drop from the mid-90s, compared to the US dollar, to about 60-ish. To what extent do you see the stimulus package having any impact on the Australian dollar? If there are other factors affecting the Australian dollar, how do you see that factoring into the way the economy will perform?

Dr Burn—I can answer the first part of the question more confidently than the second part, which is weighing up relative factors. We think that the stimulus package has improved domestic

confidence in the Australian economy, the level of investment and the level of activity, beyond what would otherwise have been the case. We think that that level of confidence and activity has given foreign investors greater confidence in the Australian economy and that has contributed to the higher dollar by making us a more attractive place for investment.

Senator XENOPHON—Is it also the case that there are other economies around the world that have been, in relative terms, much worse off than us? So is it also about the relativity of our economy compared to others, in terms of confidence?

Dr Burn—Yes, precisely. It is all to do with the relativity. That is right.

Senator XENOPHON—In terms of the dollar, to what extent do you see the stimulus package having an impact?

Dr Burn—It has had that impact on the dollar via the impact on confidence in the domestic economy, relatively speaking.

Senator XENOPHON—Mr Robertson from Macquarie Bank made a point that, because the economic outlook has improved since February, you need to put greater weight on the value for money of the thousands of projects underway—saying less weight on share haste to support aggregate demand. As a general principle, do you support the view that it is not as urgent now as it was seven or eight months ago, so that gives us a bit of time to reflect to make sure we get maximum value for taxpayer dollars in terms of the projects that are being rolled out?

Dr Burn—The longer the time between the announcement and the package the more time you have to plan it and make sure that it works better. Does that answer your question?

Senator XENOPHON—Not quite, in the sense that there was definitely an urgency in February this year for the package. Given that the economic indicators seem to be better, both here and overseas, does that mean we ought to reflect on, firstly, the nature of the projects, in terms of the implementation of the projects, and, secondly, whether we ought to be spending some of that money slightly differently, in terms of what could be seen as having a longer term productive effect on the economy?

Dr Burn—We were pretty happy with the design of the measures. They were phased to switch from households—more immediate stimulus measures—to things that would take longer to get going but would have a different pace of impact filtering through the economy. Inbuilt into the original schedule is a degree of postponement of finetuning of the planning of the measures in any case. We ought to strive for value for money to the extent that we can, regardless of the macroeconomic circumstances.

Senator XENOPHON—Could I just pare that back. Without buying into the controversy over school halls, which some say are needed and others say are not needed, are you talking about value for money to determine that a school hall is being built as efficiently as possible or, alternatively, that, rather than building a school hall, that money could be spent on another part of the school or another part of the economy that may have a longer term economic impact on the productive capacity of the economy?

Dr Burn—I think that one of the difficulties is that if you announce a program you ought to see it through.

Senator XENOPHON—Even if circumstances change?

Dr Burn—I think that when you are announcing the program you have got to understand that circumstances may well change and you should stick with that program. Because of the change in direction that you give, the signals that you give economic actors to their businesses and the people who will be employed in them, quite deliberately, you ought to stick with them. So it is more the former, making sure that you get value for money within the program as defined that I was thinking of.

Senator XENOPHON—Some economic commentators say that you have got to be careful not to overcook the goose. I think that Tony Harris in the *Financial Review* said that a few months ago, or that is what the headline was. Is there an argument to re-examine spending in the out years particularly, say, 2011-2012 when about 15 per cent of the spending is due, if circumstances do change substantially between now and, say, the next 12 to 18 months?

Dr Burn—I think that there are two points that I would make. The first is that we see the economy as currently very fragile and we do not anticipate a boom in economy anytime soon. We anticipate that the economy will remain well below the capacity utilisation levels that we were seeing only a year and a half ago. It is certainly not our assessment that the current program of fiscal spending looks as if it is overcooking the goose. That is our assessment.

Then you passed me a hypothetical question about whether circumstances could change to justify some re-examination of the package. My response to that is that we can over-segment what is going on in the economy. We have got two budgets to be announced before the second half of 2011 and there are a lot of policy actions and statements that can be made in those contexts that would influence the overall fiscal policy, and it is the overall fiscal policy that we ought to be thinking about in terms of macromanagement in 2011 rather than X per cent of the package which has already been announced.

CHAIR—I would like to ask you a question about unemployment levels, which I think are about 5.8 per cent at the moment—isn't that right?

Dr Burn—That is right, yes.

CHAIR—I have read that in a way that may be more apparent than real in that Australian employment levels have been maintained because people are working shorter hours. So in fact at the moment fewer people are out of work because more people are working shorter hours. How sustainable do you feel that is? Do you think that that is a position that can be maintained or are we going to find that increasingly people will not be so willing to work shorter hours and that the real unemployment rate will thereby rise?

Dr Burn—We anticipate that the real unemployment rate will rise and to some extent we have been surprised that it has been only 5.8 per cent in the current circumstances. We note that that switch, the growth in part-time employment and fall in full-time employment, is a major factor

that explains that. It is borne out by the Bureau of Statistics publications on underemployment and underutilisation of labour, which have both risen very sharply in the past year.

The other thing that points in that direction is that there has been quite a noticeable drop in the numbers of hours worked. We conventionally think of unemployment but we ought to be thinking more broadly in terms of underemployment because that is capturing the fuller impact including the impact on demand. These people are receiving less income because they are working fewer hours and that will have multiplier effects throughout the economy.

As I mentioned in my opening comments, that is one reason why we are very concerned about the calls for the stimulus package to be withdrawn because we think there is a degree of complacency, that people are thinking, 'Unemployment is only 5.8.' That is not telling the full story because there is much more depth and complexity to those numbers than the headline numbers would suggest.

CHAIR—If you had to give a figure for what real unemployment is, what would you suggest it might be?

Dr Burn—We think the Bureau of Statistics is measuring unemployment correctly and also that it is measuring underemployment correctly and underutilisation more broadly correctly. I think the reduction in hours worked works out at about an equivalent of 250,000 jobs fewer than a year ago. I think that is roughly the order of magnitude.

CHAIR—I am sorry I missed a bit of that.

Dr Burn—Do you want me to repeat that answer.

CHAIR—If you would, yes.

Dr Burn—If you think the bureau is measuring unemployment correctly and it is also measuring underemployment and labour underutilisation correctly, maybe not all of us are looking at the full range of data available, but I think the bureau is not doing anything wrong. I have heard the Secretary to the Treasury report that the reduction in hours worked is roughly equivalent to the loss of a quarter of a million full-time jobs.

Senator HURLEY—Looking at some of the remaining expenditure under the package, the nation building package has new funds for the Australian Rail Track Corporation, investment in university and TAFE infrastructure, a 10 per cent temporary capital investment allowance and bringing forward of road spending including the Black Spot Program and then infrastructure measures coming in next year such as the road network investment, the meta rail ports, the National Broadband Network, the clean energy initiative and further investment in tertiary education, research and innovation—they are the kinds of projects you would want governments to be doing in any case, would you not?

Dr Burn—Certainly, Senator. We note that we were calling for a major renewal of our infrastructure investment several years ago, well before any economic crisis and we notice that both the actions of the previous government in starting to address the infrastructure backlog and that, in the 2007 election of the current government, a major feature of its platform was

infrastructure investment, so we think that to package all of those programs as economic stimulus is to miscategorise them. In fact, they will of course have some stimulatory impacts but overall the key things for most of those ones you have just mentioned are about expanding supply capacity of the economy rather than stimulating the demand side of the economy. We think that is their fundamental importance. They are not essentially stimulus things at all, although of course they will have stimulatory impact.

Senator HURLEY—That was clearly part of the package design, that when it was needed that demand side would be lifted and there would be the immediate stimulus. So government might have accelerated forward those infrastructure packages but really they would have been things that the government should have been looking at doing in any case and had promised to look at doing.

Dr Burn—Yes, that is our evaluation. We raised that point in our submission, too, Senator.

CHAIR—There are no further questions. Thank you for appearing.

Committee adjourned at 2.34 pm