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Review of Reserve Bank of Australia Annual Report 2000-01

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

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Foreword

The May 2002 hearing was the first time the Reserve Bank of Australia had appeared before the Committee for 12 months and it followed the first increase in interest rates since August 2000. Therefore, much focus was on the outlook for interest rates and expectations for the economy.

Other important issues featured at the hearing were the Bank's proposed reforms to credit card schemes and the transparency of the Bank's activities.

An important new development for this hearing was the input the Committee received from the community. Prior to the hearing, I appeared on the *Today Show* (Nine Network) and invited members of the public to submit questions to ask the Governor. The Committee received 40 e-mails with many pertinent questions and the Governor's responses to these questions are contained in this report.

This hearing, like previous ones, is a very important part of the ongoing accountability of the Reserve Bank of Australia to the Federal Parliament and to the wider community.

There is no doubt through this process, and the willingness of the Governor and his senior staff to speak publicly more often than in the past, that Australians are better informed and have a much greater appreciation of the pivotal role that the Bank plays in our economic management.

Likewise, the wide publicity given to the May hearing demonstrates the value of clearly articulating current factors and the thinking likely to affect future decisions. I believe it would be reasonable to state that the Committee's hearing process has helped smooth some actual monetary policy decisions, minimise market misunderstandings and contribute to better national economic performance.

On behalf of the Committee I thank the staff at the University of Sydney in assisting with the smooth running of the hearing at MacLaurin Hall. We also thank David Richardson and Mark Tapley from the Parliamentary Library for their valuable advice.

Finally, I would like to thank the Governor of the Reserve Bank of Australia and his Deputies for their willingness to respond to the wide range of questions posed at the hearing.

Australia's economic stability and growth will be a feature at our next hearing. I look forward to questioning the Bank on this and other issues at our next hearing in Warrnambool on 6 December 2002. Holding the hearing for the first time in country Victoria reinforces the importance of including regional conditions in the Bank's decision-making process.

David Hawker MP
Chair

Membership of the Committee

Chair	Mr David Hawker MP	
Deputy Chair	Ms Anna Burke MP	
Members	Mr Anthony Albanese MP	Mr Gary Nairn MP
	Ms Teresa Gambaro MP	Mr Christopher Pyne MP (to 18 June 2002)
	Mr Alan Griffin MP	Hon Alex Somlyay MP
	Mr Peter King MP (from 18 June 2002)	Dr Andrew Southcott MP
	Mr Mark Latham MP	

Committee secretariat

Secretary	Mr Trevor Rowe
Inquiry Secretary	Ms Susan Cardell
Advisers	Mr David Richardson Mr Mark Tapley
Administrative Officer	Mr Shane Read

Terms of reference

The House of Representatives Standing Committee on Economics, Finance and Public Administration is empowered to inquire into, and report on, any matter referred to it by either the House or a Minister, including any pre-legislation proposal, bill, motion, petition, vote on expenditure, other financial matter, report or paper.

Annual reports of government departments and authorities tabled in the House stand referred to the relevant committee for any inquiry the committee may wish to make. Reports stand referred to committees in accordance with a schedule tabled by the Speaker to record the areas of responsibility of each committee.

The Reserve Bank of Australia's *Annual Report 2001* was tabled in the House of Representatives on 29 August 2001, and the Payments System Board's *Annual Report 2001* was presented to the President of the Senate 28 March 2002.

1

Introduction

Background

1.1 The House of Representatives Standing Committee on Economics, Finance and Public Administration Committee (the Committee) is responsible for monitoring the Reserve Bank of Australia (the Bank) and for ensuring its transparency and accountability to the Parliament, the financial sector, the media and the community as a whole.

1.2 The Committee continually assesses the Bank's activities, thereby providing parliamentary and public scrutiny of monetary policy.

1.3 The Committee's biannual hearings are an important element of the Bank's accountability framework. These biannual public appearances are provided for by two means:

- the August 1996 *Statement on the conduct of monetary policy*, agreed between the Treasurer, the Hon. Peter Costello MP, and the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane. The statement formalised the Bank's accountability framework and the biannual appearance before the Committee; and
- House of Representatives Standing Order 324 (b), which provides for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. The Committee may inquire into aspects of the annual reports of the Reserve Bank of Australia and the Payment Systems Board .

1.4 The biannual hearings coincide with the Bank's release of one of its quarterly statements on monetary policy. At the May 2002 hearing the Committee scrutinised the Bank's *Statement on Monetary Policy May 2002.*

Scope and conduct of the review

1.5 The Committee held its first public hearing of the 40th Parliament in Sydney on 31 May 2002 for the purpose of hearing evidence from the Reserve Bank of Australia.

1.6 Due to the November 2001 Federal Election, this was the first public hearing with the Bank for a year. Therefore, it was a significant hearing, with many issues from the preceding year to cover. Also, the hearing followed the first rise in interest rates, on 8 May 2002, since August 2000.

1.7 Discussions at the public hearing were based on the annual reports of the Bank and Payments System Board and the Bank's *Statement on Monetary Policy May 2002*.[1] The Committee also considered the Bank's December 2001 consultation document , *Reform of Credit Card Schemes in Australia*.[2]

1.8 During the hearing, a live audio feed of the event was streamed to the Parliament's website; therefore, every person interested in the Bank's evidence could hear the proceedings as they occurred via the Internet. The Committee will continue this as standard practice during public hearings with the Bank.

1.9 A transcript of the proceedings on 31 May 2002 is available on the Committee's website.[3]

1.10 Prior to the hearing the Committee held private briefings with noted economists and peak bodies in the finance industry. These briefings provided the Committee with a range of views on monetary policy, the Australian and international economy, the exchange rate, business confidence and other matters.

1.11 The Committee also held private briefings with banks and credit card companies about the Bank's proposals on credit card reform. A list of hearings, briefings and witnesses is at Appendix B.

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1 Reserve Bank of Australia, *Annual Report 2001*, Sydney, RBA; Payments System Board, *Annual Report 2001*, Sydney, RBA; and Reserve Bank of Australia, *Statement on Monetary Policy May 2002*, Sydney, RBA.

2 Reserve Bank of Australia, *Reform of Credit Card Schemes in Australia - A Consultation Document*, RBA, Sydney, December 2001,.

3 http://www.aph.gov.au/house/committee/efpa/rba0001/rbaindex.htm.

1.12 As with previous reports, this report focuses on the matters raised at the public hearing - both monetary policy and the operations of the Reserve Bank of Australia Board. The report does not aim to repeat details of the Bank's *Statement on monetary policy May 2002.*

Public input

1.13 Prior to the public hearing, the Chairman of the Committee, Mr David Hawker MP, appeared on the *Today Show* (Nine Network) and invited members of the public to submit questions for the Committee to ask the Bank. The Committee received 40 e-mails from the public containing questions relating to aspects of the Bank's operations and structure.

1.14 The Governor responded to three of these questions at the 31 May hearing and agreed to provide written responses to further questions at a later date.

1.15 The questions covered issues such as inflation, forecasting, the Australian dollar, unemployment, interest rates, credit cards, bank fees, and the structure and role of the Bank.

1.16 The Bank's response to the questions is at Appendix C.

1.17 The Committee considers that this exercise was beneficial to both the public and the Committee. The issues of concern in the community were highlighted and the questions were put to the Bank.

1.18 Prior to the biannual appearances of the Bank, the Committee receives much information on the Bank's activities from businesses, government departments and financial institutions. However, the e-mail system also provided the community with an opportunity to have a significant input into the proceedings of the Committee.

1.19 The Committee was encouraged by the e-mail received from the community and found them to contain many pertinent questions.

1.20 The Committee will accept suggested questions from the public and consider these questions for future biannual public hearings with the Bank.

2

Conduct of monetary policy

Review of forecasts presented at the May 2001 hearing

2.1 At the previous public hearing with the Committee in May 2001, the Governor of the Reserve Bank of Australia (the Bank) explained why he had reduced interest rates three times in the preceding three months.[1] In contrast, at the May 2002 public hearing, the Governor explained why he had begun to increase interest rates (see paragraph 2.29).

2.2 The easing of monetary policy in 2001 was due mainly to gloomy news from overseas. The events of September 11 exacerbated the fear that the world economy would worsen and the Bank, therefore, anticipated that the weakening prospects for the world economy would flow through to the domestic economy.

2.3 However, in the early months of 2002 it became clear to the Bank that earlier fears were not going to be realised. The Bank was receiving better news about the economy from the United States (US), Asia (excluding Japan) and Europe. The US economy had grown more than expected in the final months of 2001 and the first quarter of 2002 and the International Monetary Fund was forecasting good growth throughout the year.[2]

2.4 At the hearing in May 2001, the Bank stated that it expected 2000-01 GDP growth to be about 2%; it ended up being 1.9%. The Bank also forecast GDP growth in 2001-02 to be 3-3.5%. At the May 2002 hearing, the Bank's forecast of GDP growth for 2000-01 was 3.6%.[3]

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1 *Hansard*, 11 May 2001, p. 51.

2 *Hansard*, 31 May 2002, p. 2.

3 *Hansard*, 31 May 2002, p. 3.

2.5 The Committee considers that, given the big swings in the world economy and the international outlook over the past year, the Bank's forecasts for Australia's economy were impressive.

2.6 In May 2001 the Bank predicted the rate of inflation measured by the CPI would settle at 2.5%. At the May 2002 hearing, the Bank claimed that this prediction was spot on for the period after taking account of the GST effect. By the December 2001 quarter, however, inflation had risen to 3.1% and by the March 2002 quarter, inflation was 2.9%. The Bank acknowledged that, on average, it had slightly underestimated the rise in inflation.[4]

World economy

2.7 The Bank noted in its May 2002 *Statement on Monetary Policy* (May Statement) that forecasts for global economic growth had been revised upwards, especially in the US where it appeared the 2001 slowdown was "quite mild and short-lived."[5] Also, at the hearing, the Bank stated that 2002 would be a year of recovery for the world economy.[6]

2.8 The Bank acknowledged, however, that problems remained in the US economy—problems with the corporate sector and concerns that consumer spending was not sustainable. These concerns have materialised with the US sharemarket at its lowest level in years and problems in the corporate sector.

Economic growth

2.9 Over the course of 2001, Australia's economic growth was the highest amongst comparable OECD countries - GDP grew by 4.1% over the year. The Bank claimed that Australia had weathered a world recession without experiencing one itself.[7]

2.10 The Bank identified the main risks to the Australian economy as being the uncertainty of the US economy and the unstable political situations in the Middle East and the Indian subcontinent. On the domestic front, there is little that the Bank finds risking a downside to the Australian economy:

4 *Hansard*, 31 May 2002, p. 3.

5 RBA, *Statement on Monetary Policy*, May 2002, p. 1.

6 *Hansard*, 31 May 2002, p. 2.

7 *Hansard*, 31 May 2002, p. 2.

> The turnaround in the world economy will mean that it will be a positive force for growth over the year ahead … This should be good for exports, investment and confidence in general.[8]

2.11 However, since the hearing the unfolding El-Nino weather effect across much of Eastern Australia has raised some concerns, particularly for the agriculture sector.

Housing sector

2.12 The Bank noted in its May Statement that household spending has been expanding at a healthy pace, in part because of the consumer confidence that goes with increased household wealth associated with rising housing prices. At the hearing, the Bank made the assessment that if household credit continued to grow at 15.5% per annum, there could be a situation where the household sector as a whole would be overextended.

2.13 The Australian household debt to income ratio doubled over the past decade. It is now at about 100% along with other comparable countries such as the United Kingdom, the United States, New Zealand and Canada. However, the Bank advised that, when looking at the debt to total value of assets ratio, the rise has not been as fast: rising from 10% to 14%.[9]

2.14 The Bank told the Committee that of all household debt, 86% is housing debt. Credit card debt is only 5%.[10]

2.15 The Bank forecasts that a slowdown in residential construction is likely to be amplified by the end of the Commonwealth Additional Grant to the First Home Owners Scheme at the end of June 2002. According to the Bank, it comes at a time when there is a general oversupply of dwellings, especially in certain areas with medium-density dwellings.[11]

2.16 Despite the oversupply, house prices have been booming in all capital cities. The Bank suggested that "there is a risk that [house] prices may overshoot, as some purchasers extrapolate past movements as a guide to future capital gains". The Bank pointed to downward pressure on rental yields and high vacancy rates that may be inconsistent with "rapidly rising house prices."[12]

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8 *Hansard*, 31 May 2002, p. 4.

9 *Hansard*, 31 May 2002, p. 9.

10 *Hansard*, 31 May 2002, p. 13.

11 RBA, *Statement on Monetary Policy*, May 2002, p. 24.

12 RBA, *Statement on Monetary Policy*, May 2002, pp. 31-2.

2.17 When asked about the different prices in rural and regional Australia, the Bank responded that the boom had spread to some regional areas, such as coastal regions. While monetary policy is determined for the average of Australia, there are always going to be deviations and the Bank claimed that the deviations around the average are smaller than they were four years ago.[13]

2.18 The Bank commented that, while monetary policy cannot be set to target house prices, there is a relationship between monetary policy and house prices:

> … we have to concede that the reason there has been this big lift in house prices is largely because we have moved from a high inflation, but more particularly high interest rate environment, to a low interest rate environment.[14]

2.19 In other words, households have taken advantage of the capacity to service much bigger debts. However, the fall in interest rates had already occurred, so the Bank did not expect to see the same trend in the growth in house prices in the future.

2.20 The Bank also commented on the effect of interest rates on household debt, stating that there are two groups of people to consider: those who have mortgages (about 30% of all households) and those who are hoping to buy a house:

> There is one group that have recently got a mortgage, so their mortgage is large compared with their income. These people obviously do not want to see interest rates go up. But they do not mind house prices going up at all because they have just bought one.
>
> The other group of people aspiring to get into the housing market probably do not like to see interest rates go up either. But their biggest fear is not that; their biggest fear is an uncontrolled rapid rise in house prices.[15]

13 *Hansard*, 31 May 2002, p. 13.

14 *Hansard*, 31 May 2002, p. 14.

15 *Hansard*, 31 May 2002, p. 15.

Fiscal policy

2.21 The 2002–03 Budget was delivered following the May Statement. The Budget was an expansionary or stimulatory budget in that the net effect of policy decisions was to reduce the fiscal balance in 2002–03 and later years.[16]

2.22 This year the Budget is aiming for an increase in the underlying cash balance from a deficit of an estimated $1.2 billion in 2001–02 to a surplus in 2002–03 of $2.1 billion.

2.23 Prior to the last Federal election the Government released the 2001–02 *Mid-Year Economic and Financial Outlook*, which estimated an underlying cash balance of $0.5 billion. This later became a deficit of $1.2 billion for 2001–02.

2.24 In response to questioning about this deficit, the Bank stated that it thought the deficit was not particularly large and that fiscal policy, like monetary policy, did not need to be expansionary, because a growing economy did not require it.

2.25 Furthermore, the Bank claimed that the size of movements in the fiscal position have been small compared to what they were in the 1970 and 1980s and have not complicated movements in monetary policy. The Bank claimed that movements in fiscal policy, whether they be towards a surplus or a deficit, have to be sufficiently large to have a measurable impact on the economy before the Bank takes it into account.[17]

Exchange rate

2.26 The Bank noted in its May Statement that over the previous three months the Australian dollar had appreciated and was trading at a 15 month high of around 54 US cents.[18] The Bank explained that following the bursting of the "technology bubble" and the return of international capital flows to more normal patterns, currency traders were looking at growth performance and interest rate differentials when deciding on currency investments.[19]

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16 *1996–97 to 2002–03 Budget Papers No 1*. Note that the classification of a budget as expansionary (contractionary) is based on whether the net effect of policy decisions from one budget to the next has been to subtract from (add to) the fiscal balance.

17 *Hansard*, 31 May 2002, pp. 28 & 38-9.

18 RBA, *Statement on Monetary Policy*, May 2002, p. 17.

19 RBA, *Submission No. 2*, p.3. (See Appendix C)

2.27 The Bank claimed that the average exchange rate had increased from an exceptionally low point last year and was still nowhere near the 1990s' average of 72 cents. According to the Bank, the net effect of exchange rate movements over the past two years had been inflationary.

2.28 On the question of the rising exchange rate eroding the competitiveness of Australian industry, the Governor stated that he was not concerned. This was because he considered the exchange rate was returning to a normal level. The Governor also said that Australia's export industries have operated very well over the past decade despite higher exchange rates.[20]

Interest rates and inflation

2.29 The Committee's hearing was held immediately following the first rise in interest rates since August 2000; on 8 May 2002 official interest rates increased from 4.25% to 4.50%. Interest rates were further increased on 5 June 2002 to 4.75%. The Statement by the Bank on 8 May 2002 stated:

> To persist with a strongly expansionary policy setting would risk amplifying inflation pressures and over time, could fuel other imbalances such as the current overheating in the housing market, potentially jeopardising the economy's continued expansion.[21]

2.30 The outlook for economic growth and inflation meant that the Bank took its first steps to returning monetary policy to "a more neutral setting". The Bank claimed that unless unforseen developments intrude, they should continue along this path, while continuing to examine incoming data. The Bank maintained that the least risky way of continuing the expansion was with a neutral interest rate setting. In summarising, the Bank stated:

> … if monetary policy maintained its present stance for too much longer, there is little risk of a serious slowdown but a high risk that the economy in time would overheat. This provides the basis for our view that monetary policy should be returned to a more neutral setting.[22]

2.31 In interpreting the concept of a neutral interest rate, the Bank expressed it as a range rather than as a single point. The Governor suggested

20 *Hansard*, 31 May 2002, pp. 6 &19-20.

21 Reserve Bank of Australia, *Statement by the Governor, Mr Ian Macfarlane:: Monetary Policy*, Media Release No. 2002-10, 8 May 2002. Available from: http://www.rba.gov.au/MediaReleases/mr_02_10.html.

22 *Hansard*, 31 May 2002, p. 4.

somewhere between 3% and 3.5% in real terms (that is, actual less inflation) was appropriate. The Governor commented:

> The importance of neutrality is to remind you when you are a fair way away from it where the medium-term position should probably be, unless you are suffering some obvious contractionary influence or some obvious very expansionary influence.[23]

2.32 The Bank also referred to the size of movements in interest rates as being of considerable importance to the stability of financial markets. The Bank suggested that the world has moved into an era where changes by central banks in interest rates tend to be quite small and everyone expects them to be small. The range that people expect now is 25 basis points with 50 basis points being unusual.

2.33 The Bank explained that to get from one position to another requires a series of small steps, with pauses in between each step to gauge the effects. The Bank stated that, even without appealing to the subject of household balance sheets, the required size of the monetary policy move to get any given effect is smaller than it was in the 1980s. This is partly due to the low inflation environment.[24]

Prospects for 2002-03

2.34 The Bank forecasts economic growth during the financial year 2002-03 to be 3.5% to 4%. This would lead the Australian economy into its twelfth year of expansion.

2.35 The Bank's outlook for inflation for the same period was for it to remain at the top of a target range of 2% to 3%: the Bank expected that underlying inflation was likely to ease to around 2.5% by the end of the year 2002, but would subsequently be under gradual upward pressure, reaching the top of the target band [ie 3%] by around the end of 2003.[25]

2.36 In the 2002-03 Budget Papers inflation was forecast at 2.5% throughout the year to the June quarter 2003.[26] While this forecast was slightly at odds with the Bank's forecast, the Bank maintained that the forecasts were over different time periods and there was only about a quarter of a percent between them.[27]

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23 *Hansard*, 31 May 2002, p. 6.

24 *Hansard*, 31 May 2002, pp. 11-12.

25 RBA, *Statement on Monetary Policy*, May 2002, p. 54.

26 'Budget Strategy and Outlook 2002-03', Budget Paper No. 1, p. 3-4.

27 *Hansard*, 31 May 2002, p. 29.

2.37 The Bank noted that oil prices remain a potential problem for inflation in Australia; if oil prices stayed where they were in May 2002, they would add to the next CPI result and flow through to petrol prices. The Bank claimed this would add about 0.5% to the inflation rate over the next year.[28]

2.38 As well as good GDP growth, the Bank recognised good employment growth over the past year. Although reluctant to make a forecast, the Bank predicted that the unemployment rate would come down to below 6% given the economic expansion. [29]

2.39 The Bank also expected business investment to pick up given the high level of business confidence and expected growth in spending. [30]

2.40 The Committee notes, however, that since the hearing, world events coupled with the previously mentioned El-Nino effect raise some doubts about these forecasts.

Currency swaps

2.41 During the hearing there was discussion about international currency swaps, their affect on the exchange rate and the release of a statement by the Governor in March 2002 on the issue.

2.42 The Governor stated that it was in May 2000 when he first became aware that the Australian dollar value of the US dollar loans would likely exceed 15% of the debt on issue. He the spoke to the Secretary of Treasury in June 2000 and wrote to the Secretary in October 2000. The Governor’s first discussion with the Treasurer about the issue was in November 2000.

2.43 In December 2000, on the Governor’s advice, Treasury decided that it would not attempt to get back to the 15% as this would be counterproductive and destabilising. A review of the policy was conducted over the following six months. In the middle of 2001, a decision was made to gradually return the foreign currency exposure to zero.

2.44 The Governor advised that this time frame of six months with nothing being done despite his concerns, did not worry him because the Australian Office of Financial Management (AOFM) was not selling Australian dollars during this time. Furthermore, he stated that it was not appropriate for the Bank to buy Australian dollars from AOFM:

28 *Hansard*, 31 May 2002, p. 30.

29 *Hansard*, 31 May 2002, p. 40.

30 *Hansard*, 31 May 2002, p. 4.

> The last thing we would want to get into was a potentially open-ended situation where every time the Australian dollar fell you had to go and buy something off the AOFM and use up reserves.[31]

2.45 When the Committee met with the Bank in December 2000, the Governor was asked about the sustainability of currency swaps. The Governor raised no concern about the value of the Australian dollar. Also, when asked about the Bank's intervention policies, the Governor stated that the Bank had been quite sparing with its intervention.[32]

2.46 The issue of currency swaps was not reported in the Bank's *Annual Report 2001*. The Committee noted this exclusion at its May 2002 hearing.[33]

2.47 However, in March 2002, a statement issued by the Governor referred to the detrimental effect of the mechanical operation of the 15% policy to the macroeconomic interests of the Australian economy, saying it would involve the government selling Australian dollars into a falling market, where the Australian dollar was reaching new lows every month.[34]

2.48 At the 31 May 2002 hearing, the Governor implied that he did not put the issue into the public arena earlier because he was concerned it may have caused panic in the financial markets.[35]

2.49 The Committee is sympathetic to the Governor's comments about the possibility such public statements could cause unrest in the community and the markets. However, it creates a dilemma for the Committee in that the Bank risks misleading the Committee when it does not comment on such issues when directly asked.

2.50 One of the major roles of the Committee is to ensure the accountability of the Bank. It therefore requires the Bank to provide open and frank answers to questions put by the Committee members.

2.51 The Committee notes that the Bank's *Annual Report 2002* refers to the issue of currency swaps and the Bank's involvement beginning in the middle of the year 2000.[36] This reference, in the *Annual Report 2002*, is two years after the events surrounding this issue. The Committee considers this reporting delay unsatisfactory.

2.52 The Committee considers it important that the Bank provides the Committee with appropriate and accurate information, especially when

31 *Hansard*, 31 May 2002, p. 24.
32 *Hansard*, 11 May 2001, p. 23.
33 *Hansard*, 31 May 2002, p. 25.
34 *Hansard*, 31 May 2002, p 21.
35 *Hansard*, 31 May 2002, p. 25.
36 Reserve Bank of Australia, *Annual Report 2002*, p. 13.

directly asked. It would have been possible for the Bank to raise the issue with the Committee on an in-camera basis.

2.53 The Committee will liaise with the Bank about appropriate ways to receive accurate information from the Bank without risking detrimental effects in the markets.

3

Other matters

Credit card reform

3.1 The main public focus of the Reserve Bank of Australia's payments system powers in the last year has been the development of proposals for reform of credit card schemes.

3.2 The Reserve Bank of Australia (the Bank) described its mandate in the following manner:

> Our mandate in looking at the credit card issue was to look at competition and efficiency. We are not there in terms of consumer protection ... We are interested in the credit card as a transaction device, as part of the payments system. … The reason we got into this is that it is the most expensive transactions mechanism and yet it was the mechanism which was growing fastest.[1]

Background on credit card schemes

3.3 The Bank's reform proposals relate to the Bankcard, Mastercard and Visa schemes known as "four party schemes". Four party schemes involve four parties in the payment process: the cardholder, the issuer, the acquirer, and the merchant.

3.4 Four party schemes differ to "three party schemes" such as American Express and Diners Club where the accounts of the issuer and the acquirer are the same. They can also be contrasted to "store cards", such as the

1 *Hansard*, 31 May 2002, p. 48.

David Jones Card, which are designed for exclusive use in particular stores.

3.5 Four party schemes offer credit cards that can be used at all participating merchants. Cardholders usually have the benefit of an interest-free period if they pay their account in full at the end of each statement period. They also have the option of not paying in full and making use of a revolving line of credit. An annual fee is often levied by the card issuer.

3.6 A distinguishing feature of four party schemes is that the card issuer and the credit card acquirer may be different institutions. The four party schemes all provide for the payment of an interchange fee by the acquirer to the card issuer. The acquirer passes on this cost to the merchant as part of the merchant service fee. The interchange fee is a percentage of the value of the transaction and is designed to encourage the issuance of credit cards by creating a revenue stream for card issuers.

3.7 The Joint Study of the Bank and Australian Competition and Consumer Commission (ACCC) released in 2000 found that the average interchange fee received by issuers in 1999 was 0.95% and that interchange fees generate revenues of around $775 million a year to issuing institutions. Merchant service fees average 1.8% of the value of each credit card transaction, although, in the case of some small businesses, they can be as high as 4%.

3.8 The Joint Study also found that both card issuing and acquiring are very profitable. In the case of card issuing, costs average $1.93 per transaction but total revenues average $2.69, a mark-up over cost of 39%. In the case of credit card acquiring, costs average $0.43 but fee revenues average $0.72, a mark up of around 67%.[2]

The Bank’s proposals

3.9 The Bank released its consultation document, ‘Reform to Credit Card Schemes in Australia’ in December 2001. In its document, the Bank proposed, subject to consultation, three major changes:

- an objective, transparent and cost-based methodology for determining "interchange" fees.
- the abolition of the ‘no surcharge rule’ imposed by credit card schemes which prevents merchants from recovering from cardholders the costs of accepting credit cards; and

2 Reserve Bank of Australia and Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees*, 2000, p.45.

- the end of the restriction which prevents the entry of new players into the credit card schemes. Under the proposed reforms, specialist credit card service providers, would be eligible to enter the credit card schemes as long as they were supervised by the Australian Prudential Regulation Authority (APRA).

The consultation process and criticisms

3.10 After releasing a consultation document in December 2001, the Bank allowed interested parties until mid-March 2002 to prepare submissions. The Bank has held many meetings since then and received submissions from 28 organisations and a number from members of the public.

3.11 The Bank stated at the May 2002 hearing that it was still going through the consultation process and was working towards an outcome. The Bank stated that the consultation process had been thorough and educative for all stakeholders:

> I do not think there has ever been anywhere in the world an examination as thorough as the one that we have conducted here. The financial institutions by and large have been very cooperative and have made a lot of internal information available to us as long as we respect the firm-specific information and only ever publish averages of all firms. [3]

3.12 During the consultation process, participants in the credit card industry have been vocal and issues of concern have been widely publicised. Prior to the May 2002 hearing, the Committee held private briefings with Mastercard International, Visa International, the Australian Bankers' Association and various financial institutions regarding the credit card issue.[4]

3.13 Some of the criticisms of the Bank's proposals are:

- setting the interchange fee;
- the competitive advantage for three party schemes and store cards;
- the impact on smaller and regional issuers; and
- the impact in isolated regional areas.

Setting the interchange fee

3.14 A key criticism is that the standard to regulate the level of interchange pricing is not sufficiently detailed for any stakeholders (including existing

3 *Hansard*, 31 May 2002, p. 33.

4 See Appendix B for a full list of private briefings.

participants, merchants or consumers) to ascertain what level the interchange fee is likely to be as a result of the reform proposal. In circumstances where the Bank has statutory obligations to consult with stakeholders and to consider their views, it is not possible for the Bank to perform this obligation when stakeholders have no precise knowledge of how the reform proposal will apply in practice.

3.15 The banking industry has argued that interchange fees in Australia are amongst the lowest in the world. It has also argued that the formula used to calculate the interchange fee should include the interest free period, non-payment recovery and the production of the card. The industry has claimed the Bank has not taken these costs into account.

Competitive advantage for three party schemes and store cards

3.16 It has been claimed that the reforms will bestow a competitive advantage on three party schemes such as American Express and Diners Club and on store cards.

3.17 The Bank believes that the combination of reductions in the interchange fee and the merchant service fee for four party schemes will highlight the expensive three party schemes. Consequently, merchants will have the power to pass on the cost of the payments instrument to the customer.

3.18 The Bank stated at the May 2002 hearing that, while its proposed abolition of the surcharge rule applies to four party schemes only, the three party schemes should voluntarily withdraw this prohibition.[5]

Impact on smaller and regional issuers

3.19 The Bank has been criticised in submissions which claim that the impact of its proposed reforms, namely reductions in the interchange fee, will more adversely affect smaller and regional banks which issue credit cards. An open letter from some of the regional banks argued that smaller banks do not enjoy the same economies of scale as the majors and could not offer competitive products.

3.20 In response to this, the Bank argued that credit card issuing and acquiring is already an area where the majors dominate and since 1974 the existence of some small players has not put competitive pressure on the prices, in particular the interchange fee. Opening up access to competitors is meant to drive prices down for the users of credit cards.[6]

5 *Hansard*, 31 May 2002, p. 33.

6 *Hansard*, 31 May 2002, p. 31.

Impact in isolated regional areas

3.21 It has been argued that the abolition of the no-surcharge rule could lead to merchant profiteering particularly in isolated regional areas.

3.22 The Bank stated it did not believe that merchants in regional areas would be any different to merchants in the city in passing on the costs of using credit cards on to their customers unless they are purchasing expensive items. Besides, the Governor stated that people are paying at the moment anyway in the price of goods:

> Under this system, you will not have to pay it in the price of goods. If you wanted to use an expensive payments mechanism, yes, you might have to pay for that. But if you do not like to use an expensive payments mechanism, well, use a less expensive payments mechanism.[7]

Committee conclusions

3.23 The Committee notes the Bank's statement that it was satisfied it had all the information needed to be able to make decisions and finalise credit card reform. The Committee considers the Bank has carried out a thorough and public examination.[8]

3.24 The Committee notes that after the intense negotiations that have taken place, a number of banks have come to accept the proposals on credit card reform. These banks are now moving towards working with the changes.

3.25 The Committee will continue to monitor progress on the concerns amongst stakeholders and will closely observe the effects and outcomes of the Bank's reform measures following the release of its final report on 27 August 2002. The Committee will question the Bank about this issue at its next biannual hearing in December 2002.

ATM and Debit card fees

3.26 The Bank's October 2000 Joint Study with the ACCC identified shortcomings in competition in ATM and debit card (EFTPOS) networks.[9] The study investigated whether interchange fees reflected the costs of providing ATM services to customers and found that they did not.

7 *Hansard*, 31 May 2002, p. 34.

8 *Hansard*, 31 May 2002, p. 33.

9 Reserve Bank of Australia and Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees*, 2000, pp.42, 71.

3.27 The Committee recommended in its June 2001 Report, *Centenary of Federation Hearing,* that:

> the Reserve Bank gives the same priority to investigate ATMs and EFTPOS fees, including loyalty programs, as it gives to credit card fees.[10]

3.28 The Treasurer responded to the Report on 7 May 2002:

> The Government is determined to promote competition in banking services as a means of putting pressure on bank fees and charges whilst maximising the quality and availability of banking services to the Australian community.
>
> The Government understands that the Reserve Bank is currently working with interested parties to explore the issues and identify possible options relating to ATM and EFTPOS fees.
>
> The Government encourages the Reserve Bank to progress this work with some urgency given the importance of the issues and to undertake the necessary consultations on any proposals.

3.29 At the May 2002 hearing the Bank stated that the work on credit card reform had forced the industry to re-examine its views on ATMs and debit cards. The Bank has had a series of meetings with industry stakeholders to see whether there is a more transparent way of pricing ATMs and the same process has started with debit cards.[11]

3.30 The Committee is pleased that the Bank moved forward on this issue by releasing a consultation document in July 2002. The Committee will continue to monitor the progress on reforms to ATMs and debit cards.

The insurance industry

3.31 At the May 2002 hearing the Bank responded to questioning about the role of APRA during and after the recent events in the insurance industry and the collapse of the HIH Insurance Group.

3.32 In APRA's defence the Bank recalled that APRA was an amalgamation of three separate institutions: the bank supervision department of the Reserve Bank, the Insurance and Superannuation Commission, and the

10 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of Reserve Bank of Australia Annual Report 1999-2000*, June 2001, p. 32.

11 *Hansard*, 31 May 2002, p. 32.

Australian Financial Institutions Commission. These institutions all had different cultures and were located in different parts of Australia.

3.33 The Governor commented that it was unfortunate that APRA was just a newly formed body some associated management problems when a major insurance company collapse occurred. He stated:

> I think it would be most unfair to judge APRA as an institution or to judge its future value to the Australian economy on that one event.[12]

3.34 He added that everyone had learnt a lot following the insurance industry breakdown. The insurance industry had recognised its weaknesses and was improving.

3.35 Following the 2001 Federal Election, the Committee's Inquiry into APRA was put on hold. The Committee is awaiting the results of the current Royal Commission into the insurance industry, after which it will consider further its inquiry into the role and functions of APRA.

Collateralised debt

3.36 An issue raised at the hearing was collateralised debt obligations (CDOs) and the affect they have on the financial stability of the banking and insurance sector.

3.37 Collateralised debt is when banks package loans together with other separate credit risks and sell them to another party willing to take on that credit risk. In other words, banks securitise a lot of small loans into big parcels and sell them in the open market. The main buyers have been insurance companies.

3.38 The Bank recognised that the use of CDOs raises a system stability issue. Also the use of CDOs raises concerns about the vulnerability of companies which buy them.

3.39 The Bank claimed that APRA is in the best position to regulate the concentration of risk in insurance companies. However, the Bank also recognised that risk transfers are becoming more complicated and should continue to be monitored by regulators.[13]

12 *Hansard*, 31 May 2002, p. 36.

13 *Hansard*, 31 May 2002, p. 38.

3.40 The Committee notes the comments by the Bank and will monitor the development of these financial instruments and examine the issue with the Bank at future hearings.

Transparency of the RBA

3.41 In comparison to overseas counterparts, the Committee considers that the Bank makes fewer public speeches and appearances to outline monetary policy.

3.42 The Committee notes that the New Zealand Reserve Bank makes statements indicating likely interest rates movements over the forthcoming year. For example in announcing the latest increase in official rates from 5% to 5.50%, it said "… at this point, it appears likely that further increases in interest rates will be required over the year ahead, possibly to a greater extent than we projected in March."[14]

3.43 Also, the US Federal Reserve Bank makes an announcement after every Board meeting. When it decides not to change interest rates it nevertheless states its reasons and indicates whether it is presently biased towards a later increase or decrease.

3.44 The Reserve Bank of Australia, however, has not made monthly statements unless monetary policy is adjusted and it does not issue forward statements on interest rates over the longer term.

3.45 At the May 2001 hearing, the Bank maintained that statements after every board meeting were not required. It was concerned that if monthly statements were made, it would unduly concentrate debate on short-term monthly data. Furthermore, the Bank claimed that issuing statements every month would be difficult when there was little difference in the reasoning behind the decisions of the Bank.[15]

3.46 The Committee stated in its June 2001 Report, that it shared the concerns of the Bank that a short term approach to financial markets runs the risk of declining private investment.[16]

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14 Reserve Bank of New Zealand, Press Release, "Official Cash Rate increased to 5.5%," 15 May 2002, at http://www.rbnz.govt.nz/news/2002/0119232.html

15 *Hansard*, 11 May 2001, pp. 78-9.

16 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of the Reserve Bank of Australia Annual Report 1999-2000*, June 2001, p. 28.

3.47 During the May 2002 hearing, the Governor suggested that it is not necessary to make long term statements because the financial markets make forecasts themselves:

> … it seems to me that there is already an awful lot of information about both what the market thinks we are going to do and what we have said we think, other things being equal, will happen.[17]

3.48 The issue of the transparency of the Bank also arose in the e-mails the Committee received from members of the public before its May 2002 hearing. One question referred to the Bank not fully explaining its decisions to the public. In responding, the Bank maintained that it pays particular attention to ensuring it is transparent in explaining monetary policy actions by issuing statements after changes in monetary policy, publishing *Statements on Monetary Policy* every quarter, and giving public talks from time to time.

3.49 The Committee observes that, following the Bank's last monthly Board meeting, a one line statement that no change had been made to the cash rate was issued on the Bank's web site under the heading 'News Highlight'. The Committee understands that this method of announcement will occur on an ongoing basis and endorses this initiative.

3.50 In addition, the twice-yearly public appearances of the Bank before the Committee is a very effective means of making the Bank accountable to the Parliament and the public.[18]

3.51 The Committee will continue to monitor the public interest in the transparency of the Bank and flags this as an issue to discuss with the Bank at future public hearings.

David Hawker MP
Chair
29 August 2002

17 *Hansard*, 31 May 2002, p. 7.

18 RBA, *Submission No. 2*, p. 7. (See Appendix C)

A

Appendix A – List of submissions

Submission No.	From
1	Reserve Bank of Australia *Opening Statement to House Economics Committee's public hearing with the Reserve Bank of Australia, 31 May 2002, Sydney.*
2	Reserve Bank of Australia *RBA's Answers to e-mailed questions, 13 August 2002.* (See Appendix C)

B

Appendix B – List of hearings, briefings and witnesses

Public hearing

Friday, 31 May 2002 – Sydney

Reserve Bank of Australia

Mr Ian Macfarlane, Governor

Mr Glenn Stevens, Deputy Governor

Mr Richard Battellino, Assistant Governor (Financial Markets)

Dr Malcolm Edey, Assistant Governor (Economic)

Private briefings

Monday, 22 April 2002 - Sydney

AMP

Mr Mervyn Peacock, Chief Investment Officer, Asia / Pacific AMP Henderson Global Investors

Ms Suzanne Doyle, National Manager, Superannuation and Retirement Incomes Policy, AMP Financial Services

Ms Chloris Latham, Issues Management Executive, Office of Managing Director, AMP Financial Services

Mr Simon Doyle, Senior Australian Economist

Mr Chris Lewis, Senior Actuary, Group Tax

Mr Tony Principe, Head of Taxation – Australia AMP Limited

Mr Simon Edwards, Manager Strategic Policy, AMP Limited

Insurance Council of Australia

Mr Philip Maguire, Deputy Chief Executive Officer

Mr Robert Drummond, General Manager (Regulation)

Tuesday, 23 April 2002 - Melbourne

Business Council of Australia

Ms Katie Lahey, Chief Executive Officer

Mr Peter Burn, Assistance Director, Tax Reform

Mr Stephen Munchenberg, Assistant Director, Regulatory Reform and Sustainable Development

Ms Melinda Cilento, Chief Economist

National Australia Bank

Mr Frank Cicutto, Managing Director and Chief Executive Officer

Mr Ian McDonald, Executive General Manager, Financial Services Australia

Mr Alan Oster, Chief Economist

Mr Richard King, Group Manager, Government Relations

Mr Peter Thomas, General Manager, Payments Policy

Mr Richard Viney, RTV Consulting Pty Ltd

Mr Phil Ruthven, Chairman, IBISWorld

Bendigo Bank

Mr Rob Hunt, Managing Director

Robert Johanson, Deputy Chairman

Derek DeVrieze, Manager, Regional Development

Thursday, 23 May 2002 – Sydney

Commonwealth Bank of Australia

David Murray, Chief Executive Officer

Michael Blythe, Chief Economist

Jill Lester, Head of Group Corporate Relations

VISA International

Gordon Wheaton, Executive Vice-President, Australia and New Zealand, Visa International

Peter Vicary, Director, Corporate Communications, Australia and New Zealand, Visa International

Robin Harris, Director, Government Relations Australia Ltd

Australian Bankers' Association

David Bell, Chief Executive Officer

Nick Hosack, Economic Adviser

Ardele Blignault, Director

Wednesday, 15 May 2002 – Canberra

Mr Chris Richardson, Director, Access Economics

Thursday, 16 May 2002 – Canberra

Mastercard International

Mr Leigh Clapham, General Manager, MasterCard Australia

Mr Albert Naffah, Senior Manager, Business Development & Corporate Affairs

Mr Neil Smail, GBA Communications

C

Appendix C – RBA's Answers to e-mailed questions

Inflation and forecasting

How confident is the RBA that its inflation forecast over the next two years when it cannot forecast growth over the same timeframe?

The RBA does make forecasts of growth over the next one to two years, though it is the forecast of inflation which is the most important. The inflation forecasts represent the RBA's best estimates based on information available at the time the forecasts are made. However, like all forecasts, they are subject to significant uncertainties. Some of the sources of uncertainty that have been important recently have been those associated with exchange rate changes, movements in international oil prices and shifts in the global economic outlook, particularly in relation to the United States. The Bank's regular monetary policy statements provide a discussion of these uncertainties in the assessment of the inflation outlook.

How does the Reserve Bank justify the pursuit of anti-growth policies (the maintenance of a three per cent upper limit on CPI) when there remains massive unemployment in this country?

The RBA's inflation target of 2-3 per cent is not an 'anti-growth policy' – it is pro growth. Low inflation provides an environment in which the economy can achieve its maximum sustainable rate of growth. This framework has delivered very good outcomes for the Australian economy, with an average inflation rate of around 2½ per cent since the early 1990s, declining unemployment, and one of the highest average rates of economic growth in the developed world.

Is the RBA Governor able to explain why a more growth-friendly level of inflation would not be appropriate for Australia?

2-3 per cent inflation <u>is</u> growth friendly, whereas periods of high inflation (most notably in the 1970s) were associated with a deterioration in economic performance and lower, not higher growth. The current low inflation environment has been associated with good growth outcomes and has contributed to the expansion being more prolonged than its predecessors in the 1970s and 1980s. A policy of tolerating higher average inflation would be detrimental to economic performance and would not generate higher growth of the economy or lower unemployment.

Is the RBA aware of strong statistical evidence of a positive link between moderate rates of strategic inflation (i.e. inflation other than that resulting from external shocks and printing money) and growth – specifically that historical statistical analysis proves that a strategic rate of inflation of at least three per cent is needed to maintain a sustainable growth rate, and that growth rates of five per cent or more will generate no more than five to seven per cent inflation rates?

A number of academic studies have looked at the question of what would be the optimal rate of inflation in the long run. These studies give a range of different answers, some concluding that it is best to aim for zero inflation, others arguing that a low positive inflation rate would produce better growth outcomes, and still others supporting a mild negative inflation rate. Despite these differences, there is widespread agreement on the broader point that inflation higher than the low single-digit level tends to be harmful to economic performance.

When the Government sets the inflation target for the RBA, is it the 'headline' or the 'underlying' rate that must be kept in that range?

Since 1998, the focus of the target has been the "headline" CPI.

Does the RBA consider that it has responsibility for ensuring that the inflation index it relies on is correct? For instance, does the RBA monitor changes made to the calculation of the CPI index by the Australian Bureau of Statistics and, when changes are made, obtain figures for comparison which show what index the calculation would have produced if the method of calculation (weightings) had not been changed?

Responsibility for the construction and accuracy of the CPI rests with the ABS, which has the requisite statistical expertise. Nonetheless, the RBA takes a close interest in these matters and has made submissions to the Bureau's periodic reviews of the CPI. With regard to the specific question, the RBA closely monitors movements in the individual components of the CPI and looks at the effect of any changes in the method of calculation. Generally, changes in CPI weights do not have a major effect on the index although conceptual changes such as changes to the measurement of housing costs can have a significant effect.

Does the RBA have any influence or input when the statisticians change the index?

Changes to the construction of the CPI are generally preceded by a public review process, in the course of which the RBA would typically make a submission. The RBA also participates in consultative groups of major users of economic statistics convened by the ABS. Nonetheless it is appropriate that decisions to change the CPI rest ultimately with the Australian Statistician.

Do the statisticians have to advise the RBA of their reasons for change, and justify them by reference to the international standards for calculating inflation indices? If this is not done by the RBA, is there any other body which does it?

The Statistician would typically announce any changes to the CPI in a public document explaining the reasons for the changes made. There is no requirement for the Statistician to report directly to the RBA though the ABS does correspond with the RBA on some matters. Australia's economic statistics are generally compiled in accordance with agreed international standards.

Australian dollar

Why is the Australian dollar low against the United States dollar and English pound, when the economy is growing at a faster rate?

The Australian dollar fell substantially between January 2000 and July 2001, particularly against the US dollar. Much of this fall was due to changes in the flows of capital associated with the technology bubble in global markets. During 2000, portfolio equity capital inflow to Australia by foreigners dried up, and then turned to substantial outflows, as global investors chased the promise of high returns in US equity markets. These flows turned back around to inflows from June 2001 onwards.

The US dollar, which was benefiting from the capital inflows coming from not only Australia but many other countries (including Europe), was independently strong. The result was that the Australian dollar fell by more against it than it did against most other currencies, such as the euro.

Since mid 2001, with the bursting of the tech bubble and the return of international capital flows to more normal patterns, currency traders are again looking at "fundamentals" such as comparative growth performance and interest rate differentials when deciding on their currency investments. The result has been that the Australian dollar has risen somewhat in 2002. At the same time, the US dollar has fallen, though it remains well above its average level in the first half of the 1990s.

Unemployment

Unemployment is costing the economy billions of dollars each year. What does the RBA Governor think the "natural rate of unemployment" is? If it is higher than five per cent, why is structural unemployment so high?

The Governor has no particular view on the natural rate of unemployment, and is on record as questioning the usefulness of that concept. The Bank does not specify *ex ante* a limit as to how far that process can continue. Rather than having a fixed limit in mind, the aim of policy is to promote continued expansion of the economy consistent with low inflation. Hence, over time, the policy framework will allow the economy to continue growing at a rate consistent with declining unemployment as long as that does not lead to an unacceptable build-up of inflationary pressures.

Interest rates

When the RBA lowers the cash rate, why does it take so long for the banks to change the rates on loans but when the cash rate is increased, the banks' timeframe for changing the rates is a lot quicker? Can the lag in the banks' timing of rate changes be regulated by the RBA?

For home loans it is no longer the case that banks take longer to pass on reductions in the cash rate than increases. This year, the banks have, on average, increased mortgage rates eight days after the increase in the cash rate. This is similar to the delay of nine days in response to reductions in the cash rate in 2001. However, for small and large business, it is the case that increases in the cash rate have been passed on to borrowers more quickly than have reductions.

	Tightening cycles			Easing cycles	
	1994 average	1999-2000 average	2002 average	1996-1997 average	2001 average
Housing	16	12	8	51	9
Small business	16	12	8	35	18
Large business	16	10	8	21	16

It is important to note that banks' overall cost of funds does not move exactly in line with changes in the cash rate. Banks source a large proportion of their funds from financial markets rather than depositors. These market interest rates, such as bank bill rates, typically rise and fall in anticipation of future changes in the cash rate, so banks' cost of funds can start to change well before the cash rate changes. In recent years, there has been a tendency for these market interest rates to pre-empt increases in the cash rate by a greater margin than decreases. Given these considerations, it is not always meaningful to measure lags in banks' interest rate changes relative to the cash rate.

Will banks increase interest rates given to term deposits and savings accounts? This would be welcomed by retirees.

Interest rates on savings accounts and term deposits do not always move in line with the cash rate as, in setting them, banks take into account a range of other factors, including market interest rates and their overall need for funds. Since the start of this year, rates on fixed deposits have increased by between 0.1 and 0.5 percentage points, depending on maturity. Interest rates on transaction accounts have not increased.

Credit cards

Does the RBA consider that merchants benefit from the use of credit cards by consumers? If merchants do benefit, why is the RBA proposing a number of changes that will shift the cost almost entirely onto consumers?

This is an issue which was discussed extensively in the RBA's Consultation Document. Merchants do benefit from accepting credit cards, particularly in getting a guarantee of payment but financial institutions charge merchants a merchant service fee averaging 1.8 per cent of the value of each transaction (and up to four per cent for smaller merchants) for accepting credit cards. Debit cards (EFTPOS) also provide merchants with a guarantee of payment, but generally for a lower merchant service fee. Because of restrictions imposed by the international credit card schemes, merchants pass their credit card costs into the general level of prices. Hence, the community as a whole – including the 40 per cent of Australians who do not have credit cards – bears the costs of the credit card system.

The RBA's reforms, which amongst other things will lead to a reduction in merchant service fees for credit cards, will promote a more efficient and lower-cost payments system in Australia, from which consumers as a whole will benefit. The reforms will not shift the cost almost entirely onto credit cardholders. However, some credit card issuers may seek a greater contribution to costs from those credit cardholders who are heavily subsidised under current arrangements, viz, cardholders who settle their credit card account in full each month.

Can the RBA indicate whether it will monitor the cost impact of its proposed credit card scheme changes and ensure that any reduction in the level of interchange fees will not result in cost increases and/or service reductions to credit cardholders? What can the RBA do to ensure the banks and other financial institutions that issue credit cards do not merely shift the cost recovery from between themselves to consumers?

Credit card schemes are organised in such a way that those who ultimately bear the costs of credit cards are not necessarily those who enjoy the benefits. The costs of credit cards are borne initially by the merchant which accepts credit cards, which then passes the costs into the general level of prices – hence, the costs are borne by all consumers, whether they use a credit card or not. Credit cardholders using the revolving line of credit also contribute to credit card scheme costs by paying interest rates significantly above rates on other forms of unsecured lending. However, cardholders who settle their credit card account in full each month contribute very little directly to credit card scheme costs.

The RBA's reforms will promote a more efficient and lower-cost payments system in Australia, to the benefit of Australian consumers, by ensuring that the fees facing credit cardholders are more reflective of the costs of producing credit card services. At the same time, by allowing new issuers into the credit card market, the RBA reforms will give a boost to competition. As experience in the residential mortgage market shows, it is the arrival or the threat of new entrants that will put pressure on all credit card issuers to keep their fees to cardholders down.

Why can't credit card interest rates be required to be reduced when other interest rates fall (eg mortgage and investment rates)?

Like all other interest rates, credit card interest rates in Australia are determined by market forces. When these rates do not move as much, or as quickly, as some other interest rates, competition is unlikely to be working as it should. One reason is that consumers may not shop around actively for lower interest rate credit cards because they believe (incorrectly as it often turns out) that they will not end up as borrowers. Another reason is that the credit card schemes in Australia impose restrictions on which institutions can issue credit cards. The RBA's proposed reforms will liberalise entry into credit card issuing by allowing non-financial institutions with skills and financial substance to be eligible to participate, provided they meet appropriate prudential standards. It is worth recalling that it was the entry of specialist mortgage originators that spurred competition in the residential mortgage market.

How can the RBA objectively examine the arrangements for credit cards when it earns significant revenues from the main competitor of credit cards: cash?

The Payments System Board of the RBA has a mandate to promote efficiency and competition in Australia's payment system, consistent with the overall stability of the financial system. The Board is carrying out its mandate by examining the price incentives facing consumers of different payment services and the strength of competition in providing these services. Where markets for payment services are not efficient and competitive, the Board looks to identify and remove any unnecessary restrictions. Reform of credit card schemes is only part of the Board's agenda in the retail payments area.

The RBA's traditional role as issuer of Australia's currency notes has no bearing on the Payment System Board's mandate. The RBA is simply the wholesaler of currency notes to the commercial banking system and provides whatever volume of currency notes is demanded; any profits from that activity are paid directly to the Government. It is the commercial banks that determine the cost of cash to the public by the charges they levy on consumers for cash transactions at branches and ATMs, and on businesses for distributing, collecting and depositing cash. Several years ago the RBA ceased providing subsidised specialised cash services. In its wider business, the RBA has actively promoted the adoption of more efficient payment methods. Over the last decade, for example, it has led the way in moving government payments such as pensions and other benefits from cheques, which are relatively expensive for both the Government and the beneficiary, to direct credits to accounts at financial institutions. These changes have increased the efficiency of the payment system and produced substantial resource savings to all parties involved.

Bank fees

Why is there a lot of emphasis placed by the RBA on interest rates, but very little on bank fees?

The RBA focuses on interest rates for monetary policy because it is through changes in interest rates that monetary policy is implemented. That said, the RBA does recognise the importance of bank fees in the overall cost of borrowing or running a transaction account. It collects, analyses and publishes a range of information on bank fees. Figures on bank fees are published in Table F6 of the *Reserve Bank Bulletin* and articles on bank fees are in the June 1999 and July 2001 issues of the RBA's *Bulletin*.

Structure and role of the Reserve Bank

Why is it that the Reserve Bank's Board members, particularly those representing businesses and the unions, are not encouraged to engage in active public debate over the stance of monetary policy, as they are in the United Kingdom?

The structures of the Reserve Bank Board and the Bank of England's Monetary Policy Committee (MPC) are very different and they operate in different ways. In addition to the Governor and Deputy Governor, the Reserve Bank Board is composed of a majority of "outside" members who are not full-time central bankers, plus the Secretary to the Treasury. The MPC is composed of five executive members of the Bank of England plus four external non-executive members all chosen for their expertise in monetary policy and who devote the majority of their time to the Bank of England.

The Reserve Bank Board is a decision-making Board and operates like most corporate boards in that when decisions are made they are announced and explained by the Governor, the Chairman of the Board, on behalf of the Board. For the MPC, while a single decision emerges from each meeting, the nine members are individually accountable for their judgments.

Given that the RBA is independent of Government and does not fully explain its decisions to the public, to whom does the RBA justify itself?

The RBA is independent of the Government in setting interest rates to achieve the agreed objectives for policy, but is responsible to Parliament for its actions. The RBA does fully explain its decisions. Changes in monetary policy are announced along with a detailed explanation, the next morning after the meetings of the Reserve Bank Board. The RBA also publishes *Statements on Monetary Policy* each quarter, providing a detailed analysis of the economy and financial markets and from time to time the Governor, Deputy Governor and senior officials give public talks on various aspects of the RBA's activities.

A further key element of the RBA's accountability is the twice-yearly appearance by the Governor, Deputy Governor and senior officials before the House of Representatives Standing Committee on Economics, Finance and Public Administration. At these public hearings, the most recent of which was of course in May, the members of the Parliamentary Committee question the Governor on a range of issues, particularly focusing on the conduct of monetary policy.

Why is it that the econometric models used by the RBA in its calculations are never made publicly available for scrutiny?

They are published. A comprehensive description of the RBA's econometric modelling work was most recently published in June 2000 as Research Discussion Paper 2000-05 and is available on the Bank's website (www.rba.gov.au). That said, modelling plays only a relatively small direct role in policy decision.

Can the Governor please explain why the RBA should be independent of the Australian people (by being independent from the Australian Government and therefore the voters), whose livelihood they affect through the operation of monetary policy?

The RBA is not independent of the Australian people. It is a Commonwealth statutory authority, established under an Act of Parliament, the *Reserve Bank Act 1959*. This Act gives the Reserve Bank Board the power to determine the Bank's monetary policy, but sets out the broad goal of that policy. The Government has confirmed the RBA's independence in the day-to-day operation of monetary policy in the 1966 *Statement on the Conduct of Monetary Policy* which was prepared to contribute to a better understanding in the community of the relationship between the RBA and the Government.

Recognising this independence, the RBA pays particular attention to ensuring it is transparent in explaining monetary policy actions and being accountable for its decisions. The twice-yearly appearances by the Governor, Deputy Governor and senior officials before the House of Representatives Standing Committee on Economics, Finance and Public Administration are an important part of the accountability arrangements.

Is the RBA a Government Department? If it is not, who are its shareholders?

The RBA is not a Government department. It is a Commonwealth statutory authority, established under an Act of Parliament, the *Reserve Bank Act 1959*. In other words, it is "owned' by the Australian Government.

Reserve Bank of Australia
Sydney
13 August 2002