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Review of the Reserve Bank of Australia Annual Report 2004 (First Report)

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

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Contents

Foreword

The committee's February 2005 public hearing with the Governor of the Reserve Bank of Australia (RBA and the Bank) was the first meeting for the newly established House Economics Committee in the 41st parliament. The RBA continued to report on a healthy economy which is in its fourteenth year of continuous growth. However, with many good news stories there is a cautionary tale; demand continues to outrun supply and this is starting to stimulate inflation.

The February hearing came at a time when there had been no change in interest rates for 15 months. Much speculation surrounded this hearing as many forecasters were predicting another rise in rates as early as March 2005. While the prospect of further interest rate rises dominated much of the discussion, other issues examined at the hearing included the impact of the world economy on Australia, housing and household indebtedness and supply side constraints. As on previous occasions, the committee also sought an update on the reform agenda of the payments system.

The evidence given at the hearing enabled the committee to examine the setting of monetary policy. Whilst monetary policy is not used directly as an instrument to influence the supply side, the Governor did outline what he saw as major impediments to maintaining a GDP growth rate of 3.5 per cent or better over the long term.

The hearing continued to provide the community, financial sector, and the media with a valuable opportunity to monitor the way in which the Bank conducts monetary policy in Australia.

At the hearing, the committee welcomed a large number of school students and their teachers from Sydney and surrounds. Given the great interest shown by senior secondary students in these hearings over recent years, the committee obtained questions from selected schools and these were put to the RBA as part of the formal proceedings. It was gratifying to see that students of economics are receiving a good grounding in monetary policy as evidenced by the quality and insightfulness of their questions.

On behalf of the committee, I thank the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane, for his discussion and for the contribution of his staff. The committee also appreciates the pre hearing briefings from Mr Chris Richardson, Director, Access Economics and Mr Saul Eslake, Chief Economist, ANZ. I also appreciate the hard work of the Deputy Chair, Chris Bowen and our fellow committee members and that of our secretariat staff and advisers.

The Hon Bruce Baird MP
Chairman

Membership of the Committee

Chair	The Hon Bruce Baird MP	
Deputy Chair	Mr Chris Bowen MP	
Members	Mr Steven Ciobo MP	Mr Andrew Robb AO MP
	Mr Joel Fitzgibbon MP	The Hon Alex Somlyay MP
	Ms Sharon Grierson MP	Mr Lindsay Tanner MP
	Mr Stewart McArthur MP	Mr Malcolm Turnbull MP

Committee secretariat

Committee secretary	Ms Beverley Forbes
Inquiry secretary	Mr Peter Keele
Adviser	Mr David Richardson, Parliamentary Library
Administrative officers	Mr Andrew McGowan
	Mr Robert Nicol

Terms of reference

The House of Representatives Standing Committee on Economics, Finance and Public Administration is empowered to inquire into, and report on the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.

The focus of the hearing was the *Reserve Bank of Australia annual report 2004* which was tabled in the House of Representatives on 17 November 2004 and the *Payments System Board annual report 2004* which was tabled in the House of Representatives on 30 November 2004.

List of abbreviations

ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
ASX	Australian Stock Exchange
CAD	Current Account Deficit
EFTPOS	Electronic Funds Transfer at Point of Sale
GDP	Gross Domestic Product
NAB	National Australia Bank
PSB	Payments System Board
RBA or the Bank	Reserve Bank of Australia

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Introduction

Background

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

1.2 The Reserve Bank Governor's appearances before the committee at biannual public hearings are an important element of the Bank's accountability framework. The details of these are set out in the August 1996 *Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Peter Costello MP, and the Governor, Mr Ian Macfarlane, whereby the Bank's accountability framework and the biannual appearance before the committee have been formalised.[1] A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the House Economics committee may inquire into

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1 A second *Statement on the Conduct of Monetary Policy* was released in July 2003, building on the 1996 Statement. Both documents can be viewed on the RBA's website at www.rba.gov.au/MonetaryPolicy.

aspects of the annual reports of the RBA and the Bank's Payments System Board.

1.3 The biannual hearings coincide with the release of one of the RBA's quarterly statements on monetary policy. At the February 2005 hearing in Sydney, the committee scrutinised the RBA's *Statement on Monetary Policy* for February 2005.

Scope and conduct of the review

1.4 In the 41st parliament the first public hearing of the House Economics committee with the RBA was held in Sydney on 18 February 2005.

1.5 As the proceedings for the Sydney hearing occurred they were streamed over the internet through the Parliament's website, allowing interested parties to hear the proceedings as they occurred. The Governor's opening statement was taken as a submission and the transcript of the hearing is available on the committee's website.[2]

1.6 Before the hearing, the committee received a private briefing from Mr Chris Richardson, Director, Access Economics and Mr Saul Eslake, Chief Economist, ANZ Bank. These briefings provided valuable background information for the committee and perspectives on issues for discussion at the public hearing.

1.7 The committee was delighted that the Sydney hearing was well attended by members of the public and 150 students from secondary schools.

1.8 The committee's public hearings with the RBA continue to bring issues of monetary policy into the public arena and also have assisted in providing a public face to parliamentary committees and the RBA. The committee welcomes the Governor's frank and open comments at the hearing. In addition, the hearing is also an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.9 As with the previous committee's reports, this report of this committee's work focuses on matters raised at the public hearing. The report does not repeat the detail in the *Statement on Monetary Policy*, the RBA's annual report nor proceedings of the public hearing. These

2 See: http://www.aph.gov.au/house/committee/efpa/RBA2003_04/index.htm

documents may be viewed through the RBA's website[3] or on the committee's website[4]

3 See: www.rba.gov.au

4 See: http://www.aph.gov.au/house/committee/efpa/RBA2003_04/index.htm

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Monetary policy and related issues

Overview of the 2004 year

2.1 The RBA stated that, throughout 2004 the strong global economy continued to push up commodity prices which in turn provided Australia with a significant stimulus to national income and spending, with the prospect of more to come.[1] Over the last two years the price of Australia base metals exports have risen by 40 per cent.[2]

2.2 Domestically, both business and consumer confidence remained high throughout 2004.[3] The Governor said this was reflected in the performance of the Australian Stock Market which out performed other major stock markets around the world.[4]

2.3 The RBA reported that on the domestic front, the cooling of the domestic housing market during 2004 was associated with an easing in credit growth to the household sector from the exceptionally high rates seen in previous years.[5] Nevertheless, the growth of credit to

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1 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2005, RBA, Sydney, p 1 (hereafter referred to as *Statement on Monetary Policy*, February 2005).

2 *Statement on Monetary Policy*, February 2005, p 1.

3 *Statement on Monetary Policy*, February 2005, p 2.

4 *Transcript,* 18 February 2005, p 13; *Statement on Monetary Policy*, February 2005, p 2.

5 *Statement on Monetary Policy*, February 2005, p 3.

both household and business sectors remained high and was still growing at around at 12 per cent at the end of 2004.[6]

2.4 Inflationary outcomes for 2004 were higher than expected Mr Macfarlane said, coming in at 2.6 per cent for the year. The rapidly rising $(A) during 2002 and 2003 helped keep inflationary pressures down but according to the Governor when the exchange rate levels out the influence on inflation evaporates.[7] Once the exchange rate influences have worked their way through, they no longer offset the domestically-sourced inflationary pressures. These inflationary pressures are showing up in higher producer prices associated with rising material costs and strong demand pressures.[8]

2.5 The RBA Board during the course of 2004 judged,

> … that a further tightening of monetary policy would probably be required in due course, but that there was no need for action in the short term…[9]

Forecasts for 2005

2.6 The RBA stated in its February 2005 Statement that after a strong year in 2004 the world economy continued to grow.[10] More particularly, the US economy was expanding at a steady pace and China's economy grew at nearly 10 per cent.[11] In other parts of the world, economic recovery was continuing. The tsunami will have a minor economic impact on some parts of Asia where reduced growth will occur in the short term. Overall, it is expected that the world economy will continue to grow in 2005 at an above average pace but not as strong as was experienced in 2004.[12]

2.7 According to the February Statement, with the exception of a surprisingly weak outcome for growth in the September quarter, the range of other available information suggests growth will continue well into 2005. However, there is one key issue that will need to be

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6 *Statement on Monetary Policy*, February 2005, p 3.

7 *Transcript,* 18 February 2005, pp 4, 7.

8 *Statement on Monetary Policy*, February 2005, p 3.

9 *Statement on Monetary Policy,* February 2005, p 3.

10 *Statement on Monetary Policy*, February 2005, p 1.

11 *Statement on Monetary Policy*, February 2005, p 1.

12 *Statement on Monetary Policy*, February 2005, p 1.

addressed; that is, the extent to which the ongoing growth of demand might give rise to capacity constraints and, consequently, upward pressure on wage and price inflation.[13] As the Governor outlined in his opening remarks to the hearing, Australia was now into its fourteenth year of expansion and, as would be expected, there is much less spare capacity today than was the case in the early phases of expansion.[14]

2.8 Over the past 14 years annual growth has averaged 3.7 per cent. In June 2004, the RBA was still forecasting a growth rate of 3.75 per cent for the year to December 2004.[15] At this hearing, the RBA revised this downwards to around 2 per cent .[16] The actual figure for the year ending December 2004 came in at 1.5 per cent.[17]

2.9 Mr Macfarlane told the committee that there are several possible explanations for the difference. First, he suggested that the National Accounts paint a picture which is not entirely consistent with other indicators.[18] Employment growth has been booming throughout 2004, consumer and business confidence have been at near record levels, the stock market is at record highs, company profitability has risen and tax receipts are up. He said these indicators would suggest a completely different outlook.

2.10 Mr Macfarlane suggested that the slowdown in growth is explained by the supply side of the economy.[19] A good deal of his subsequent discussion went into the nature of those constraints. He went on to say that demand cannot be sustained at the recent levels and if it continued to outpace output growth then the Australian economy would risk rises in inflation.[20] He said that there are signs that demand is starting to slow and gross domestic product (GDP) growth will be in the range of 2 to 3 per cent rather than 3 to 4 per cent for a period of time.[21]

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13 *Statement on Monetary Policy*, February 2005, p 2.

14 *Transcript,* 18 February 2005, p 2; *Statement on Monetary Policy*, February 2005, p 2.

15 *Transcript,* 4 June 2004, Sydney, p 2.

16 *Transcript,* 18 February 2005, pp 2-3.

17 Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product Main Features Production Chain Volume Measures*, cat. 5206.0 ABS, 2 March 2005, ABS, Canberra, p 2.

18 *Transcript,* 18 February 2005, p 3; *Statement on Monetary Policy*, February 2005, p 2.

19 *Transcript,* 18 February 2005, p 4.

20 *Transcript,* 18 February 2005, p 4.

21 *Transcript*, 18 February 2005, p 4.

2.11 On a cautionary note, Mr Macfarlane said that there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances that have got the economy into trouble in the past.[22] During the course of the hearing he was at pains to dispel any boom-bust scenarios. He said if household borrowings and house prices had continued to grow at 20 per cent in 2004, then Australia would have had the makings of a serious boom-bust situation. Fortunately that did not occur; borrowings dropped back to around 13 per cent and house prices fell. In the past, the bust has often been associated with very big domestic imbalances as evidenced in the late eighties and early nineties.[23] He stated that if the RBA continued to adopt a "…relatively small, well-timed movements…" approach to interest rates then everything should stay under control.[24]

Inflation targeting and monetary policy

> In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time.[25]

2.12 In June 2004 at the Sydney hearing Mr Macfarlane stated that the RBA predictions for underlying inflation would remain steady at about 2 per cent through 2004, moving up to about 2.5 per cent towards the end of 2005.[26]

2.13 In February 2005 at the Sydney hearing Mr Macfarlane said,

> On inflation: our forecast of a year ago for underlying inflation in the four quarters to December 2004, was 1½ per cent. At our June meeting here in this building in Sydney with the committee, we had raised it to two per cent.

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22 *Transcript,* 18 February 2005, p 5.

23 *Transcript,* 18 February 2005, pp 3, 13.

24 *Transcript,* 18 February 2005, p 13.

25 *Second Statement on the Conduct of Monetary Policy: The Treasurer and the Governor of the Reserve Bank*, July 2003, www.rba.gov.au/Monetary Policy/, viewed 8 March 2005, p 2.

26 *Transcript*, 4 June 2004, p 2.

> In the event, underlying inflation came in at 2¼ per cent while the headline figure was 2.6 per cent…
>
> Looking ahead, we forecast gradual rises in underlying inflation, with it reaching 2½ per cent by the end of this year and three per cent by end of 2006...[27]

2.14 The inflationary-targeting regime that has been put in place means that adjustments can be made along the way thus helping to overcome inflationary expectations.[28]

2.15 As expected, the February hearing devoted a considerable amount of time to the question of where interest rates are heading over the medium term. Media attention around the time of the hearing also focussed on the issue of interest rates. Many commentators were predicting another rise of 25 points as early as March 2005 with some going further and suggesting another rise of 25 points by the middle of the year.

2.16 It therefore came as no surprise to the committee when Mr Macfarlane repeated what had been stated in recent Statements on Monetary Policy, that it, it is more likely that interest rates will rise given where we are presently in the current cycle.[29]

> …So I think the public are aware that at this phase of a cycle it is more likely that interest rates will go up than that they will go the other way…[30]

2.17 Mr Macfarlane told the committee that the RBA had been forecasting for some time that inflation was going to follow a "U" shaped path.[31] He said the trough of that path was forecast to occur around late 2004 – early 2005. What did not occur was a fall to 1.5 per cent but rather a bottoming out at 2.25 per cent. According to the RBA, this has meant that the "U" shaped path is a bit flatter, and inflation has started to rise again, and therefore upward interest rate adjustments cannot be ruled out.[32]

2.18 The committee notes that operating within a margin of 2- 3 per cent, on the face of it, suggests a very precise and timely response by the RBA to movements in inflation. Mr Macfarlane pointed out that the

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27 *Transcript,* 18 February 2005, pp 4-5.

28 *Transcript*, 18 February 2005, p 2.

29 *Transcript,* 18 February 2005, p 5.

30 *Transcript*, 18 February 2005, p 5.

31 *Transcript,* 18 February 2005, p 23.

32 *Transcript,* 18 February 2005, p 23.

RBA inflation target is simply that; a target. He said that the RBA is not suggesting that it should never be outside that range, in fact he said 45 per cent of the time it has been either above or below.[33] He stressed that what is important is that if it is above or below, measures will be in place to bring it back to within the 2-3 per cent range.

2.19 A lot of media attention is focussed on the exact timing of an increase in rates but Mr Macfarlane commented that as long as you get the general movement correct, and not leave the economy out of alignment, then the timing is not critical as far as the big picture is concerned.[34] He said,

> …Whether you move one month or the next month or the one before, in the big picture, is not really of paramount importance to the economy, although it is of paramount importance to the people sitting on a money market desk.[35]

2.20 The Governor, when talking about the various economic indicators, said that the picture is actually quite a complicated one and, the Board is always faced with a lot of conflicting evidence.[36] In forecasting there are always some pieces of the jigsaw puzzle that are missing and therefore, the Board cannot wait until everything fits into place because that would be probably too late to act.[37] He went on to say that published statistics tell what has happened ex-post; the Board needs information that gives a picture of what is happening now and is likely to happen in the short to medium term.[38]

2.21 Mr Macfarlane said that at the end of the day you have to come to an on-balance judgement because you will never be in a position where everything is telling you the same thing.[39]

2.22 On 2 March 2005, the Bank raised the cash rate by 25 basic points to 5.5 per cent. On balance, despite the very low GDP growth rate of 1.5 per cent for the year ending December 2004, domestic and global demand have both been growing strongly and signs are emerging that capacity constraints are starting to put upward pressure on wage and production prices, the Board concluded that:

33 *Transcript,* 18 February 2005, p 24.
34 *Transcript,* 18 February 2005, p 6.
35 *Transcript,* 18 February 2005, p 6.
36 *Transcript,* 18 February 2005, p 5.
37 *Transcript,* 18 February 2005, p 5.
38 *Transcript,* 18 February 2005, p 7.
39 *Transcript*, 18 February 2005, p 12.

> In these circumstances, the Board judged that an increase in the cash rate was warranted in order to reduce the risk of an unacceptable rise in inflation in the medium term.[40]

2.23 At its next meeting with the RBA, the committee will review the events in detail that led to the decision to increase rates.

Exchange rates and external trade

2.24 Generally, over a 12 to 18 month period, according to the Governor, a change in the exchange rate can be the biggest influence on inflation, that is, an appreciating dollar will help keep inflation down, but once the dollar settles at a new level, this impact on inflation dissipates.[41]

2.25 The current exchange rate is about 10 per cent above the long term average (post fixed exchange rate regime) and to a large extent has been very much influenced by factors outside of Australia's control. Australia's terms of trade has risen steadily in recent years and Australia has maintained higher interest rates compared to the US, Europe and Japan. According to Mr Macfarlane, the US dollar has fallen by roughly the same amount against all floating exchange rate countries (30 to 47 per cent).[42]

2.26 In response to a question about the risk associated with a $(US) continuing to fall (something that is outside Australia's sphere of influence), Mr Macfarlane stated that this would be something that would cause the RBA to reassess monetary policy.[43] If such a scenario developed then rate rises would more than likely compound the problems associated with an overvalued dollar.

2.27 According to recent reports, the likelihood of this happening may have increased in recent times as reports suggest that other central banks and private investors may be contemplating wider diversification of their future increases in forex reserves into currencies other than $(US).[44] This could put further upward pressure on the $(A) and, if oil prices remain above $(US) 50 a barrel, this

40 Statement by the Governor, Mr Ian Macfarlane: Monetary policy. *RBA Media Release*, 2 March 2005, p 1.

41 *Transcript*, 18 February 2005, p 7.

42 *Transcript*, 18 February 2005, p 12.

43 *Transcript*, 18 February 2005, p 18.

44 Bloomberg.com. *Dollar declines as Bank of Korea plans to diversify reserves.* www.bloomberg .com/apps/news, viewed 4 March 2005.

would also tend to dampen any decision to increase rates in the foreseeable future.

2.28 One major consequence of a globalised and freely floating exchange rate has been the ability of countries to maintain higher current account deficits (CAD) because of the willingness of global financial markets to take risks in other countries and in other currencies.[45] Under a regime of fixed exchange rates, monetary policy may have been called on to push up rates so as to finance these deficits.

2.29 Australia's current deficit which is running at around 6.75 per cent of GDP would not have been possible under a fixed exchange regime according to Mr Macfarlane.[46] He said the willingness of foreigners to finance someone else's deficit has greatly reduced the need for drastic intervention by government and central banks.[47] The ability of the US to continue to operate with a huge CAD, albeit, that it is only 5.5 per cent of GDP, is due to the extremely mobile international capital.[48]

2.30 The RBA stated that what is disappointing about Australia's current trade position is that we have been unable to match the world growth in demand for raw materials and manufactured goods even though our terms of trade gain over the last 2-3 years has been of the order of 20-25 per cent.[49] The terms of trade rose by 2.3 per cent in the September quarter 2004, reaching a 30 year high, and is likely to increase further in the short term, due in the main to the ravenous appetite for basic materials by China, which has resulted in spectacular price increases for commodities such as iron and coal.[50] He noted that on the other hand, there has been an increase in competitiveness for manufactured goods because of China's presence in the world market and this has had a downward pressure on prices for such goods.[51] Australia has run into some major bottlenecks that have resulted in an inability to increase supply (volume) to satisfy this demand for basic materials. These bottlenecks and supply constraints are discussed later in this chapter.

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45 *Transcript,* 18 February 2005, p 11.

46 *Transcript,* 18 February 2005, p 11.

47 *Transcript,* 18 February 2005, p 11.

48 *Transcript*, 18 February 2005, p 11.

49 *Transcript,* 18 February 2005, p 21; *Statement on Monetary Policy*, February 2005, pp 2, 37.

50 *Transcript,* 18 February 2005, p 20; *Statement on Monetary Policy*, February 2005, p 41.

51 *Transcript,* 18 February 2005, p 21.

United States and the financial markets

2.31 The Governor spoke about interest rates in other parts of the world. He said that like Australia, the rest of the world was in a similar phase of economic expansion and therefore rate rises would more than likely occur.[52]

2.32 Mr Macfarlane also stated that he believed that we have been through a period where the world economy has conducted a rather risky experiment of having very, low interest rates – 1 per cent in the US, zero in Japan and 2 per cent in the Euro area.[53] He said that the US and many other countries are trying to remedy this, but Japan and the Euro countries are still maintaining their low rates.

2.33 Given the low rates, financial markets around the world have been searching for higher returns on their funds and thus taking on more and more risk.[54] The likely fallout will impact more on the financial sector rather than on inflation. This is of concern to the US according to Mr Macfarlane.[55] Interestingly, the Governor told the previous committee at its 2004 hearing that while Australia did not match the very low interest rates in the US and Japan, the RBA could not completely ignore the fact that around the world, Australia has had the lowest interest rates since the post war period.[56]

2.34 He said that if one extrapolates from this, then any upward pressure on interest rates around the world would, at some point in time, increase the pressure on the RBA to increase rates at home.

2.35 In response to a question about Paul Volcker's prediction that the US will experience a financial crisis in the next five years because of its twin deficits, Mr Macfarlane said that he was more worried about the US budget deficit than its CAD.[57] He went on to say that the sophistication of financial markets had reached a point where risk-taking has not been fully assessed and this is something of a concern that he would share with Mr Volcker.[58]

2.36 In the RBA's *Financial Stability Review*, September 2004 it stated,

52 *Transcript,* 18 February 2005, pp 5, 9.

53 *Transcript,* 18 February 2005, p 9.

54 *Transcript,* 18 February 2005, p 9; *Statement on Monetary Policy*, February 2005, p 25.

55 *Transcript,* 18 February 2005, p 9.

56 *Transcript,* 4 June 2004, p 8.

57 *Transcript,* 18 February 2005, p 27.

58 *Transcript,* 18 February 2005, p 27.

> Looking overseas, the condition of the international banking system has improved recently, assisted by a stronger world economy. This, however, does not mean that the global situation is without risk...The concern here is that investors who have borrowed heavily on the assumption of continuing low interest rates may need to unwind their positions quickly—a turn of events that could lead to an abrupt repricing of financial assets and, potentially, market instability...These market risks are less pronounced in Australia, partly reflecting the fact that interest rates were never cut to very low levels here—although, of course, it is impossible for local markets to be quarantined from overseas events.[59]

2.37 The committee notes that Australia is part of the global economy and it cannot remove itself from these events and the setting of monetary policy must take account of international developments.

Housing and household debt

2.38 The RBA stated,

> Demand for housing finance now appears to have stopped falling after the declines earlier in 2004, and there are some tentative signs that it is starting to pick up. After being broadly flat for several months at a little above $12 billion per month, housing loan approvals rose by about 5 per cent in November. Over the six months to December, housing credit grew at an annualised rate of 12½ per cent, down from 22½ per cent over the second half of 2003. Within the total, investor loan approvals and credit have slowed much more than the owner-occupier components...[60]

2.39 The Governor was asked to comment on a recent OECD survey which tended to suggest that the recent investment decisions in the housing market were not inappropriate. The report stated,

> ...with general government finances in surplus…Australia's current account reflects private saving and investment decisions. And with structural reform having stripped out

59 Reserve Bank of Australia, *Financial Stability Review,* September 2004, RBA, Sydney, p 2.

60 *Statement on Monetary Policy*, February 2005, p 30.

> many distortions from the economy, private sector saving and investment decisions are likely to be efficient, with capital flows reflecting informed decisions about relative investment opportunities.[61]

2.40 In response, Mr Macfarlane said that,

> …as we moved from a current account deficit of about two per cent of GDP three years ago to what we have now, of 6¾ …about 1½ per cent was due to a reduction in savings—and three per cent was due to an increase in investment. Normally you would say that that is great…But of that three per cent of GDP increase in investment, 1.7 per cent of it was in residential construction…[62]

2.41 He said that whilst it is true that the CAD reflects private sector decisions, there are incentives in the system which can distort the pattern. Mr Macfarlane said therefore in hindsight, it may have been more prudent to invest in more productive assets which are earning a higher rate of return.[63]

2.42 The committee notes that a lot has already been said about Australian's preoccupation with housing in earlier reports by previous House Economics Committees. At the February 2005 hearing, the Governor stated that he was very pleased that house prices had fallen throughout most of 2004 and that growth in borrowings were down from the extraordinary levels achieved in 2003.[64] However, he noted that growth in borrowings are still continuing at a fairly rapid rate (still around 15 per cent) but a lot of this is in owner occupier rather than investor housing. Even though housing has moved back towards, something the Bank said it would regard as more normal, the debt to income ratio is still rising.[65]

2.43 He reported the debt servicing ratio is 9.3 per cent which is the highest it has been. Previously when it reached similar levels interest rates were around 17 per cent.[66] This in itself is quite an achievement but the fact still remains that households are still carrying so much debt and more susceptible to interest rate changes. Mr Macfarlane

61 *OECD Economic Survey: Australia.* December 2004, Volume 2004, Issue 18, p 49. http://dpl/Ejournals/OECDEconomicSurvey-Australia.pdf, viewed 9 March 2005.

62 *Transcript,* 18 February 2005, p 10.

63 *Transcript,* 18 February 2005, pp 10, 28.

64 *Transcript,* 18 February 2005, pp 3, 17.

65 *Transcript,* 18 February 2005, p 17.

66 *Transcript,* 18 February 2005, p 28.

noted the RBA was aware of this and therefore needed to use monetary policy carefully and sparingly so as not to cause a major upheaval.[67] Under these circumstances, the RBA believes monetary policy becomes a very powerful weapon.[68]

2.44 The Governor was also asked to explain why he was not prepared to take the retail and growth data at face value. Mr Macfarlane stressed that it was difficult to get a complete picture from the available published statistics.[69] He said some figures suggest a slowing in retail trade while disposable income is rising at around 8.2 per cent and household credit is still on the increase. Households have also had the benefit of some recent tax cuts. Finally, because Australia has one of the largest home ownership rates in the world, much of our spending is influenced by the wealth effect generated by this one particular asset.[70]

2.45 The data presented by the RBA in its February Statement, stated that household consumption remained strong in 2004, increasing by 5.4 per cent over the year to September quarter.[71] It also showed that disposable income grew strongly, outpacing growth in consumption over this period resulting in some gains in savings.[72]

2.46 Against this trend, the RBA noted that retail sales were weaker than expected in October and November 2004. According to the RBA, this may have been due to rising petrol prices which meant less for discretionary spending.[73] Or as was suggested by one member of the committee at the hearing, the decline may in part be due to slowing in household wealth resulting from weakness in house prices.[74]

Australian share market

2.47 Notwithstanding the fact that Australians have a preoccupation with housing, money still flowed freely into the Australian stock market in 2004 lifting the Australian Stock Exchange (ASX) to record levels. In

67 *Transcript,* 18 February 2005, p 28.

68 *Transcript*, 18 February 2005, p 28.

69 *Transcript,* 18 February 2005, p 19.

70 *Transcript,* 18 February 2005, pp 17-18.

71 *Statement on Monetary Policy*, February 2005, p 27.

72 *Statement on Monetary Policy*, February 2005, p 27.

73 *Statement on Monetary Policy*, February 2005, pp 27, 28.

74 *Transcript,* 18 February 2005, pp 16, 18; *Statement on Monetary Policy*, February 2005, p 28.

fact, the stock market rose by around 25 per cent during the year. Given the concerns raised by the RBA about house price increases in 2003, the committee was interested to know whether the RBA shared similar concerns about the stock market.

2.48 In particular, the committee asked the Governor about the price to earnings ratio (PE) moving up to 21 compared to the long run average of around 15-16 and whether this was another asset that needed deflating.[75] The committee questioned whether money flowed from one over-heated market into another?

2.49 Mr Macfarlane replied that the move from housing to shares in 2004 was a good thing. It helped take the heat out of housing. However, he said he did not believe that the stock market was over heated because most of the price rises have been underpinned by record profits.[76]

2.50 Mr Macfarlane also said he saw no immediate problems that margin lending had risen by 21 per cent over the past year. He said the increase was from a small base and it amounted to only 15 per cent of personal borrowings which represents about 2 per cent of household borrowings.[77]

2.51 According to an ASX Share Ownership Study released on 24 February 2005, the number of people who own shares leapt by more than 600,000 last year as strong share gains and faltering property prices extended Australian's love affair with the stock market. Some 55 per cent of adults now own shares, up from 51 per cent last year and just 20 per cent in 1994.[78]

Supply side constraints

2.52 The issue of barriers to further growth came up very early at the hearings when Mr Macfarlane stated that Australia was now entering a phase where capacity constraints were becoming a much bigger influence on how monetary policy is set.[79]

2.53 He said that the most obvious capacity constraint was showing up in the economy's inability to grow exports to meet the worldwide

75 *Transcript,* 18 February 2005, p 30.

76 *Transcript,* 18 February 2005, p 30.

77 *Transcript,* 18 February 2005, p 31.

78 ASX Share Ownership Study - 2004 findings. *Media Release,* 24 February 2005, p 1.

79 *Transcript,* 18 February 2005, p 6.

growth in demand for basic materials. Unfortunately, according to Mr Macfarlane, no one saw it coming; not even the most experienced people in the resource sector.[80]

2.54 He said that although monetary policy has to take the supply side as a given when setting rates, it is becoming harder and harder to make those decisions without thinking about supply-enhancing policies.[81] He stressed that if Australia wishes to realise economic growth in the order of 3.5 per cent or more per annum, then it will have to address the supply side bottlenecks.[82] This can be done in three ways:

- increase capital through new investment; or
- increase the supply of labour; or
- increase productivity.

The Governor went on to briefly outline his views on those constraints.

Business fixed investment (infrastructure)

2.55 He said currently, there are many incentives for people to invest in housing. This has seen 1.7 of the 3 per cent in investment growth going into housing, rather than business fixed investment/infrastructure. Mr Macfarlane suggested that this may need to be revisited. Although business fixed investment was slow to respond to the resources boom, the Governor believed there is every indication that this should pick up given the profitability of the resource companies and the continuing high world demand for their products.[83]

2.56 The committee believes that on the face of the following data, this appears to be happening already.

2.57 Australian Bureau of Statistics (ABS) figures released on 2 March 2005, showed business capital expenditure jumping by 3.3 per cent in the December quarter to $14.8 billion. According to the ABS, this has pushed annual business investment by 9.4 per cent for the year. This is in contrast to retail turnover which fell by 0.3 per cent in the quarter ending December 2004 and rising by only 1.9 per cent for the year. Similarly, housing finance for owner-occupier rose by only

80 *Transcript,* 18 February 2005, pp 7-8.

81 *Transcript,* 18 February 2005, p 25.

82 *Transcript,* 18 February 2005, p 25.

83 *Transcript,* 18 February 2005, p 25.

0.9 per cent for the quarter and actually fell by 6.1 per cent over the year.[84]

2.58 Taken at face value, the committee believes that these figures would suggest that some of the supply bottlenecks are being addressed by business on the back of strong profits and continuing high demand on export markets.

2.59 The committee also cites the huge uptake of investment in the minerals and energy sector which has more than 207 projects on the books; 73 of which are committed or already under construction at a cost of $24.3 billion as further evidence of some of these bottlenecks being addressed. If the remaining 134 projects get the go ahead, Australia could see a further injection of $72.5 billion.[85]

Labour market

2.60 One of the factors raised by the Governor as evidence that there are inflationary pressures, concerned the inability of businesses to find suitable labour.[86]

2.61 According to the RBA,

> …The thing called the wage price index has only been going since 1998, so we do not have a long history of it; we do not really know how it behaves over the cycle. These things seem to have shown very little in the way of increase. Enterprise bargaining, similarly: there is a bit of an increase but it is not much. In fact, looking at these two measures, you would have to say at the moment that their growth is just about right: the wage price index is about 3.5 per cent, the enterprise bargaining about 4.2 per cent. Both of these figures are utterly consistent with the maintenance of inflation somewhere ….between two and three...[87]

2.62 Whilst acknowledging these statistics, the Governor believed that these figures are not telling the full story. He said, according to other reputable surveys (NAB, Westpac, ACCI, Sensis), their findings are all saying that business has reached a point where their biggest

84 Australian Bureau of Statistics. *Key National Indicators*, ABS, Canberra, 2 March 2005.

85 Haine I (ABARE). Minerals and energy: major development projects. *Australian Commodities*, vol 11, no 4, December quarter 2004, pp 6-10.

86 *Transcript,* 18 February 2005, pp 2, 25-26.

87 *Transcript,* 18 February 2005, pp 6-7.

constraint to expansion is their ability to hire suitable labour.[88] He said, the RBA's own surveys tell the same story that there is definitely pressure in the pipeline, but it has not as yet shown up in the aggregate figures and we would hope that it does not.[89]

2.63 Not all members of the committee shared this concern, in particular, that the current labour shortages were driving up wage cost pressures and by implication, starting to impact on inflation. However, every member of the committee agree that if the wage decision involving a 31 per cent pay rise over three years for electricity workers at Energex in Queensland became the norm, without any offsetting productivity gains, then it would be inflationary.[90]

2.64 When Mr Macfarlane spoke about the supply side difficulties he commented that the RBA constantly hears about the difficulties of getting skilled labour and to a lesser extent, unskilled labour.[91] He said in particular, the skilled trades people are getting older and there are not enough new ones in the pipeline.[92]

2.65 The committee notes that no one would disagree about the demographics of the workforce and the need to maintain a steady supply of new skilled personnel, but not all commentators agree that this situation is likely to result in a wages break out.

2.66 The RBA also reported,

> Labour market conditions continued to improve in the December quarter. Employment grew by 1.2 per cent in the quarter, which is well above the trend growth. Employment was 2.6 per cent higher over the year, and full-time employment accounted for almost three-quarters of the total increase. This strength in employment is somewhat at odds with the relatively weak rate of growth indicated in the national accounts.
>
> …the unemployment rate, which fell to 5.1 per cent...is the lowest rate recorded since late 1976...[93]

88 *Transcript,* 18 February 2005, p 7.
89 *Transcript*, 18 February 2005, p 7.
90 *Transcript,* 18 February 2005, p 29.
91 *Transcript,* 18 February 2005, p 25.
92 *Transcript*, 18 February 2005, p 26.
93 *Statement on Monetary Policy*, February 2005, pp 33-34.

2.67 The committee notes that the wage price index released by the ABS on 22 February 2005 showed a rise of only one per cent in the December quarter and by only 3.6 per cent for the year.[94] Even on the RBA's margins this figure is consistent with the maintenance of inflation within the preferred band of 2-3 per cent.

2.68 In a slight departure from normal proceedings, the committee asked for, and received several questions from students in attendance. One question went to this issue; that is, notwithstanding the remarkable decline in unemployment from over 10 per cent to 5.1 per cent today, is there any likelihood that unemployment could fall to around 2 per cent as experienced in the 1950s, 1960s and early 1970s?[95] The Governor said it was unlikely due to the more complex system we have to operate in today.[96] He explained that if this is the case then we may have to conclude that continuing demand for labour will eventually feed through to higher wages costs and hence fuel inflationary expectations.

Welfare and tax reform

2.69 The Governor stated that part of Australia's labour shortage can be identified by the very low labour force participation rate for males over 45 years of age. Retirement incomes policy and high marginal tax rates have a bearing on this development.[97]

2.70 He said another area that is affecting participation rates is the ability to facilitate the return to work for many people on social security benefits. Mr Macfarlane suggested that Australia needs to review why over 600,000 people remain on disability pensions. Every effort must be made to try and remove some of the barriers and disincentives for those people wishing to re-enter the workforce.[98]

Productivity and industrial relations reform

2.71 The RBA noted that significant increases in productivity were achieved in the 1990s but this momentum needs to be maintained. According to Mr Macfarlane, things are starting to slow down or if one believes the statistics, we may have gone backwards.[99] He

94 Australian Bureau of Statistics. *Labour Price Index, Australia*. cat. 6345.0 ABS, 23 February 2005, Canberra, p 1.

95 *Transcript,* 18 February 2005, p 33.

96 *Transcript,* 18 February 2005, p 33.

97 *Transcript,* 18 February 2005, p 26.

98 *Transcript,* 18 February 2005, p 26.

99 *Transcript,* 18 February 2005, p 26.

suggested that if undertaken in the right environment, employers and employees should look at what can be further done to achieve win-win situations.[100]

2.72 The committee appreciated Mr Macfarlane's frankness and his willingness to identify what he saw as issues to be addressed on the supply side.

100 *Transcript,* 18 February 2005, p 26.

3

Payments system

3.1 A safe and efficient payments system is essential to support the day to day business of the Australian economy and to settle transactions of the Australian financial markets.

3.2 The RBA has important regulatory responsibilities for the payments system and plays a key role in its operations. These responsibilities include:

- regulatory responsibility for the payments system, controlling risk and promoting efficiency and competition;
- providing facilities for final settlement of payments system obligation; and
- participating in the system as banker for the Australian Government, some state governments and other customers.[1]

3.3 The Governor advised that in recent years greater attention has been given to the efficiency of the payments system; in particular, looking into the various means of payment and the associated costs of providing and using them. This is particularly important in the retail payments system as over 10 million non-cash payments are made every day.[2] People can use five basic ways to pay for something

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1 Reserve Bank of Australia. About the Australian payments system. www.rba.gov.au/Payments *System/AustralianPaymentsSystem/about_the australian_payments_system*, viewed 7 March 2005, p 2.

2 *Payments System Board Annual Report 2004*, RBA, Sydney, p 1.

namely, cash, cheque, credit card, debit card (EFTPOS) and electronic crediting and debiting.[3]

3.4 At the hearing, Mr Macfarlane commented that when the RBA started the payments system reform process it was concerned that the most expensive of these five main types of payments, the credit card, was the most used by customers.[4] The RBA stressed that in a purely competitive market this would not be the outcome.[5]

3.5 He said the first reform was to reduce "interchange fees" of which customers were unaware. Interchange fees were reduced by 50 per cent which reduced these fees amongst banks by around $500 million per annum.[6]

3.6 He noted that one of the main impediments to reform is the lack of competition in the payments area and lack of transparency with respect to the true cost of using each type of payment.[7]

3.7 In the case of credit cards, it is the merchant who is initially paying the costs to use the credit card to the issuer (banks). In most cases, the cardholder sees it as a free instrument and in some cases it also has additional benefits by way of frequent flyers points or other bonus schemes.[8]

3.8 Each time someone uses a debit card or EFTPOS, the issuer (bank) does not receive an income, therefore it is in the issuer's (bank) interest to get people to use the form of payment that maximises its return.[9]

3.9 According to Mr Macfarlane, the simplest way to make the payments system more efficient is to enable the merchants to charge the customers for using different types of cards etc.[10] He noted that the removal of the "no surcharge rule" has not been rushed by most merchants because they have had over 50 years of absorbing those fees and have factored those fees into their business.[11]

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3 *Transcript*, 18 February 2005, p 33.

4 *Payments System Board Annual Report 2004*, 2004, RBA, Sydney, p 2.

5 *Transcript,* 18 February 2005, p 33.

6 *Transcript,* 18 February 2005, p 33.

7 *Transcript,* 18 February 2005, p 34.

8 *Transcript,* 18 February 2005, pp 34-35.

9 *Transcript,* 18 February 2005, p 34.

10 *Transcript*, 18 February 2005, p 35.

11 *Transcript,* 18 February 2005, p 35.

3.10 The RBA stated that unlike the other areas of banking and finance, such as mortgages where there are 30 banks and 200 mortgage brokers, the payments system is not conducive to the same level of competition. This system is a network and for any new entrant to participate they will have to get agreements with everyone in the system to accept the use of their proposed system of payment.[12]

3.11 The solution, according to the Governor, may not be regulation but rather, trying to open up these areas to more competition.

3.12 He noted that not surprisingly, one of the barriers to making the payments system more transparent and efficient is the legal challenges from some of the key stakeholders as evidenced by:

- merchants challenge to the Payments System Board (PSB) when attempting to reduce debit cards fees to zero which was seen as a form of collective price setting; and
- Visa's and MasterCard's attempt to stop the PSB from lowering credit card interchange fees.

3.13 On the 24 February 2005, the PSB released draft standards for the EFTPOS and Visa Debit payments systems for public comment. The proposed standards seek to address the distortions in price and costs of using the different types of payments.[13] The draft standards propose to:

- reduce the EFTPOS interchange fees paid to the merchant's bank from around 20 cents per transaction to around five cents.[14] Currently this fee brings in approximately $170 million per annum which is divided up between the banks and the big retailers;[15]
- reduce the Visa Debit interchange fee paid to the cardholder's bank from an average of around 40 cents, to a maximum of around 15 cents;[16] and
- remove the current requirement that merchant's accepting Visa credit cards also have to accept Visa Debit cards (it would also

12 *Transcript,* 18 February 2005, pp 35-36.

13 Payments System Reform, *RBA Media Release,* 24 February 2005, p 1.

14 Payments System Reform, *RBA Media Release,* 24 February 2005, p 1.

15 This is an industry estimate based on an average EFTPOS interchange fee of 20 cents multiplied by the total number of EFTPOS transactions per year (refer Reserve Bank of Australia, Statistical Tables, *Bulletin,* February 2005, RBA, Sydney, Table C2 Debit Card Statistics, p S28.)

16 Payments System Reform, *RBA Media Release,* 24 February 2005, p 1.

formally apply the no-surcharge standard to the Visa Debit scheme).[17]

3.14 In the same media release, the RBA announced that is does not intend, at the current time, to regulate the American Express and Diners Club card payments system and in return, both American Express and Diners Club have agreed to:

- reword clauses in their merchant agreements that currently prohibit merchants from encouraging cardholders to use another card; and
- publish the average merchant service fee in Australia on a quarterly basis. Diners Club has already done so.[18]

3.15 The Bank also called for submissions on whether the credit card interchange fees standards should be amended so that the same benchmark interchange fee applies in all schemes (Bankcard, MasterCard and Visa).[19]

3.16 The committee will discuss the progress of these reforms at its next meeting with the RBA. It will also follow any public campaigns undertaken by the PSB to raise awareness about the fees and charges applied to the various methods of payment. In this regard, the committee was pleased to read an article by Ross Gittins in the Sydney Morning Herald, 2 March 2005, entitled "Unravelling the plastic money maze".[20] This article sets out to trace the different fees and charges arising from the use of credit cards, EFTPOS and Visa debit in simple plain language for the community.

The Hon Bruce Baird MP

Committee Chairman

17 March 2005

17 Payments System Reform, *RBA Media Release,* 24 February 2005, p 2.

18 Payments System Reform, *RBA Media Release,* 24 February 2005, pp 2-3.

19 Payments System Reform, *RBA Media Release,* 24 February 2005, p 3.

20 Ross Gittins. Unravelling the plastic money maze. *Sydney Morning Herald,* 2 March 2005.

A

Appendix A – Submission

Number	Provided by
1	Reserve Bank of Australia (*Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, public hearing Sydney, 18 February 2005).*

B

Appendix B – Hearing, briefings, and witnesses

Public hearing

Friday 18 February 2005 – Sydney

Reserve Bank of Australia

Mr Ian Macfarlane, Governor
Mr Glenn Stevens, Deputy Governor
Mr Ric Battellino, Assistant Governor (Financial Markets)
Dr Malcolm Edey, Assistant Governor (Economics)
Dr Philip Lowe, Assistant Governor (Financial System)

Private briefings

Thursday 10 February 2005–Canberra

Mr Saul Eslake, Chief Economist, ANZ Bank

Mr Chris Richardson, Director, Access Economics