The Parliament of the Commonwealth of Australia

The Centenary of Federation Hearing:

Review of the Reserve Bank of Australia Annual Report 1999-2000

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

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Foreword

In this Centenary of Federation year, it was very appropriate that the House of Representatives Economics Committee's public hearing with the Reserve Bank of Australia was held in the Legislative Council Chamber in Melbourne. The chamber is rich in symbolism. The chamber was used by the Australian Senate from 1901 until the opening of the Federal Parliament in Canberra in 1927. It also was in that chamber, in 1928, that Sir Robert Menzies, Australia's longest serving Prime Minister, began his political career before he went on to the lower house and then to the House of Representatives.

This hearing was a Centenary of Federation national and Victorian event. Our parliamentary committee event on 11 May followed:

- the centenary of the first meeting of the Commonwealth Parliament in 1901 - held in the Royal Exhibition Building on 9 May; and
- the centenary meetings of the Houses of the Commonwealth Parliament - held in the Legislative Council and Legislative Assembly Chambers on 10 May.

We thank the organisers of both the national and Victorian committee for including this hearing in these historic celebrations.

Again, this was an interesting and controversial hearing. As expected the focus was on the change in direction of monetary policy and the significant drop in interest rates. While the Governor was very cautious in his comments, he remained optimistic about the future of the Australian economy, while stressing that changes to the Australian economic landscape are extremely dependent upon developments in the US.

The fall in the growth of the housing sector of over 37% in the six months to December 2000 turned a relatively unexceptional slowdown into a small contraction of GDP. Everyone is glad to see the forward projections are more positive.

The committee has recommended that in future conduct of monetary policy when there is a major structural change in economic policy, the Bank should give appropriate weight to examining business confidence data.

At the hearing, the committee again focussed significant attention on the transparency and accountability of the Bank, as well as looking at the Bank's designation of credit card fees. The committee has recommended that the Bank give the same priority to investigate ATMs and EFTPOS fees, including loyalty programs, as it is giving to credit card fees. In addition, it also considered the recent collapse of HIH and the need for legislative change in some areas of both general insurance and superannuation. The committee's work continues to be an opportunity for probing community concerns with monetary policy as well as giving the Reserve Bank a public forum in which to raise significant areas of concern to it.

In undertaking this scrutiny work, the Committee appreciates the assistance and cooperation it received from the Governor and Assistant Governors of the Bank and their staff. It also appreciates the range of other private briefings it received.

We thank the Hon Bruce Chamberlain MLC for making it possible to hold the hearing in the Legislative Council Chamber, the Usher of the Black Rod (Dr Ray Wright) and the staff of the Council for assisting to ensure the smooth running of the hearing. The committee is also grateful to Mr Bernie Harris (Executive Coordinator, Centenary of Parliament) for facilitating this hearing to become a Centenary of Federation event.

Finally, I thank the members of the House Economics Committee for their contributions to the public hearing and to this report.

David Hawker MP
Chair

Membership of the Committee

Chair	Mr D P M Hawker MP	
Deputy Chair	Ms A E Burke MP	
Members	Mr A N Albanese MP	Ms T Plibersek MP
	Ms T Gambaro MP	Mr C M Pyne MP
	Mrs K E Hull MP	Hon A M Somlyay MP
	Mr M W Latham MP	Dr A J Southcott MP

Committee secretariat

Secretary	Ms B Forbes
Research Officers	Mr S Anderson Ms M Atkin
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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 2000* was tabled in the House of Representatives on 5 September 2000, and the Payments System Board's *Annual Report 2000* was tabled on 8 November 2000.

List of abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
APRA	Australian Prudential Regulation Authority
ATM	automated teller machine
CEDA	Committee for the Economic Development of Australia
EFTPOS	Electronic Funds Transfer Point Of Sale
GST	goods and services tax

List of recommendations

Recommendation 1

The committee recommends that in the future conduct of monetary policy when there is a major structural change in economic policy, the Bank should give appropriate weight to examining business confidence data. (para 2.68)

Recommendation 2

The committee recommends that the Reserve Bank gives the same priority to investigate ATMs and EFTPOS fees, including loyalty programs, as it gives to credit card fees. (para 3.36)

1

Introduction

Background

1.1 The Reserve Bank Governor's biannual appearance before the House Economics Committee has become a focus for accountability and transparency of the Bank to the parliament, the financial sector, the media and the community as a whole.

1.2 There are two reasons for the Governor's appearance before the committee. The first is 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. This statement formalised the Bank's accountability framework through the publication of a statement on the conduct of monetary policy and the Governor's biannual appearance before the House Economics Committee.

1.3 The second reason for the appearance of the Reserve Bank is the 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.

1.4 Since 1994 the Bank's activities have been assessed by the committee, thus providing a continuous period of public scrutiny of monetary policy.

1.5 While the information is closely observed nationally, it is increasingly being noted internationally.

Scope and conduct of the review

1.6 After its meeting on 1 December 2000, the committee made arrangements to hold its next public hearing with the Reserve Bank in May 2001. Initially it was to be held in Sydney, but as logistics developed, the hearing was moved to Melbourne.

1.7 The public hearing with the Reserve Bank of Australia was registered as an official Centenary of Federation event, and endorsed nationally and by the State Government of Victoria. It was held in Parliament House, Melbourne, as the third parliamentary event after, firstly, the formal centenary of the first meeting of the Commonwealth Parliament and, secondly, the celebratory separate centenary meetings of the Senate and the House of Representatives.

1.8 The public hearing was held on 11 May 2001 in the Victorian Legislative Council Chamber. From 1901 until the opening of the Federal Parliament in Canberra in 1927, the Australian Senate used the Chamber. We were also told that it was the first time a parliamentary committee had held a hearing there. This was indeed a grand venue and apt for a Centenary of Federation hearing.

1.9 The committee appreciated the support provided by the President of the Legislative Council, the Hon Bruce Chamberlain MLC, in making it possible to use the Chamber for this historic public hearing. During the hearing, a live audio feed of the event was streamed to the Parliament's website[1], and a transcript of the proceedings is now available on the committee's website.[2]

1.10 Special guests present during the hearing included the Speaker of the House of Representatives (the Hon Neil Andrew MP), the President of the Legislative Council (the Hon Bruce Chamberlain MLC) and several State MPs.

1.11 As with the last hearing in Wagga Wagga in December 2000, the committee invited local tertiary and senior secondary economics students to attend the hearing. It was wonderful to have a large number of student representatives from: Loreto Mandeville Hall, Melbourne Girls' Grammar, Melbourne Boys' Grammar, Presentation College, Ruyton Girls' School, St Kevin's College, Strathcona Baptist Girls, and the University of Melbourne.

1 http: / / www.aph.gov.au.

2 http: / / www.aph.gov.au / hansard / reps / commttee / r4757.pdf.

1.12 Discussions at the public hearing were based on the Bank's and Payments System Board annual reports 1999-2000 and the Bank's *Statement on monetary policy May 2001*.[3]

1.13 The committee regularly holds private briefings with noted economists prior to each public hearing. On this occasion, the committee was briefed by the following: the Australian Chamber of Commerce and Industry - Dr Steven Kates, Chief Economist; the Housing Industry Association - Dr Ron Silberberg, Managing Director; Macquarie Bank Limited - Mr Bill Shields, Chief Economist, and Mr Richard Gibbs, Head of Economics, and Professor Adrian Pagan, Professor of Economics at the Australian National University, and also a former board member of the Reserve Bank of Australia. These briefings presented to the committee some alternative views on monetary policy, the Australian economy, the exchange rate, business confidence and other matters.

1.14 As with previous reports, this report focuses on the matters raised at the public hearing - both monetary policy and the operations of the Bank, especially the payments system and the operation of the Reserve Bank of Australia Board. The report does not aim to repeat details of the Bank's S*tatement on monetary policy May 2001*.

3 *Reserve Bank of Australia annual report 2000*. Sydney, RBA, 107p; Reserve Bank of Australia. 2000. *Payments System Board annual report 2000*. Sydney, RBA, 46p; and Reserve Bank of Australia. 2001. *Statement on monetary policy May 2001*. Sydney, RBA, 50p.

2

Conduct of monetary policy

Review of forecasts presented in December 2000

2.1 In the opening statement at the December 2000 hearing, the Reserve Bank warned that the solid economic growth over the past decade should not lead to complacency, and that the Bank should always be looking to see where the risks to the economy are likely to come from.[1]

2.2 The May 2001 hearing began with the Bank outlining the major changes that have occurred since the December hearing:

> Two major changes to the economic landscape occurred shortly after we met in December. The first was that the outlook for the world economy changed rather sharply in a downward direction at the turn of the year. This was mainly a result of developments in the United States, but it was widespread enough to cause significant downward revisions to world growth prospects. The second major change was that it became apparent that the Australian economy had been a lot weaker in the second half of 2000 than we had formerly thought…[2]

2.3 In the United States, an economic slowdown has become apparent, which is in line with the view expressed by the Reserve Bank in December. A weaker US economy is expected to have a major impact on its major trading partners, and consequently the world economy.[3]

2.4 The world economy grew at a rate of 4.8% in 2000. In October 2000, the International Monetary Fund predicted growth of 4.2% for 2001, however,

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1 Evidence p 3.

2 Evidence p 49.

3 Evidence pp 3-4.

this has since been lowered to 3.2% in response to the US economic downturn. This is in line with the Reserve Bank's prediction at the December hearing of a slowing in world growth.[4] This issue is further examined in the next section.

2.5 In December the Bank agreed with Treasury's forecast for Australian economic growth of 4% for 2000-01. At the May hearing, the Bank updated the forecast and said '…It now looks like being about half that figure…' at around 2%.[5] The downward revision of economic growth was because of the 0.6% contraction in December quarter, which was not anticipated by the Bank. It explained that:

> …The answer lies mostly in the exceptionally large decline in dwelling investment, which was a result of the transitional effects of introducing the GST…[6]

2.6 The Bank noted that its December 2000 forecast of GDP was well and truly overtaken by events and that this was only the second time out of eight occasions in these reviews that it had overestimated the outlook for growth. On the other six occasions it had made a small underestimate.[7]

2.7 The Bank later clarified that if the fall in dwelling investment was removed, then the rest of the economy grew at an actual rate of 2% during the second half of 2000, or at an annual rate of 4%. This would have been a modest slowdown in growth from the rapid growth of 4.7% in 1999-2000.[8]

2.8 The Bank stated that the economy is slowing, but that it is not in recession.[9] More recently, this has been confirmed by growth in the March 2001 quarter of 1.1% and growth for the year to the March 2001 quarter of 2.1%.[10]

2.9 Employment was forecast to remain strong, with some moderation from the very high growth in late 1999 and early 2000. Since the December hearing, the labour market has softened with the construction sector being the main area of weakness. Between August 2000 and February 2001,

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4 Reserve Bank of Australia. May 2001. *Statement on monetary policy May 2001*. Sydney, RBA, p 8; and Evidence p 5.

5 Evidence p 51.

6 *Statement on monetary policy May 2001* pp 1-2.

7 Evidence p 51.

8 Evidence p 56.

9 Evidence p 61.

10 Australian Bureau of Statistics. 6 June 2001. *Australian National Accounts: National income, expenditure and product*, 16p.

employment in the construction sector fell by 48,300 while employment in all the other sectors rose by 40,800.[11]

2.10 Inflation, as measured by the CPI, has been below Reserve Bank expectations in both the September and December quarters, prompting the Bank to conclude that it is '…well under control…' The Bank reduced its forecast for 2001 to 2.5% from the forecast of 3% at the December hearing.[12]

2.11 Overall, the Bank was cautious about the short-term outlook for the economy, especially the impact of a slowing world economy. The fall in growth in the December quarter was a great disappointment to the Bank, as well as to the committee. The committee trusts that the slowdown will be short lived, especially after the recent news of the significant improvement in domestic economic growth in the March 2001 quarter.

World economy

2.12 In the Reserve Bank's opening statement, it stressed that:

> …we had undergone a relatively abrupt change in our view of the world … it became clear that the world was entering a new phase of its business cycle, a fact recognised in most countries…[13]

2.13 At the beginning of 2001, the '…outlook for the world economy changed rather sharply in a downward direction…'[14] The growth prospects of the US economy, which has been the powerhouse of the world economy over the past decade, deteriorated and a slowdown in its economic growth occurred.[15] The US economy grew by 0.5% of GDP in the March quarter and by 2.7% for the year to March 2001, which is less than half of the rate recorded for the year to June 2000.[16]

2.14 The Reserve Bank believes that the prospects for the US economy hinge on the impact of several economic imbalances, which have the potential to cause a very pronounced slowdown. The imbalances include:

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11 Evidence pp 50-1; and see also *Statement on monetary policy May 2001* p 25.
12 Evidence pp 3, 51, 55.
13 Evidence p 51; and see also Evidence p 50.
14 Evidence p 49.
15 Evidence p 49.
16 *Statement on monetary policy May 2001* p 4.

- share prices that are very high by historical standards. Households over the past few years have been relying upon share price gains and savings to support their consumption spending;[17]
- easing of the investment boom especially in information technology and telecommunications. In the March 2001 quarter investment in these sectors fell by 6%;[18] and
- the strong US dollar, which is inhibiting the US economy's ability to export its way out of a slowdown.[19]

2.15 The effects of the US slowdown are being felt around the world. In its *Statement on monetary policy May 2001*, the Bank reported that:

> …Asia has been one of the regions most affected by the slowing of US demand…[and] the largest economy in the region – Japan – continues to suffer from continuing domestic problems such as impaired balance sheets, weak asset prices, and deflation in prices for goods and services…[20]

2.16 In response to the economic slowdown, the US Federal Reserve has moved very quickly to reduce interest rates five times by a total of 250 basis points since 3 January 2001. The Reserve Bank said that:

> …Such an action could not be expected to prevent a slowing in the United States economy, but it would reduce the chances of something more serious, such as a recession, occurring. [21]

2.17 The Bank went on to say that:

> …the world faces two paths: one which is based on modest slowdown for the US, as has happened to date – and all the evidence is still pointing in that direction – and the alternative path is US recession, in which case everyone would feel the effects of that.[22]

2.18 With the prospect of lower world growth, most countries have loosened their monetary policy stance to cushion the impact of the world economic slowdown on their economies. The only notable exceptions have been Europe and the UK, which only reduced their official interest rates early in May 2001 by one quarter of a per cent.[23]

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17 Evidence pp 49, 56.
18 Evidence pp 49, 55.
19 Evidence p 49.
20 *Statement on monetary policy May 2001* p 1.
21 Evidence p 49.
22 Evidence p 56.
23 Evidence p 50.

2.19 The Bank stressed that the 'very big' question for Australia over the next 18 months is the extent to which the Australian economy is dependent on the world economy and the potential effect of a US slowdown on the world economy. '…[T]he world economy is looking so much towards the US for its lead…'[24]

2.20 The impact of the US slowdown on Australia's Asian trading partners will be very crucial for Australia's export sector. With the Japanese economy continuing to remain weak, and the aggregate growth rate for the countries in the East Asian area (excluding China) of zero for 2000, the outlook for Australian exporters is uncertain. However, a low exchange rate should continue to provide support for Australian exports.[25]

Economic growth

2.21 At the December 2000 hearing, the Bank highlighted that over the next year it expected the composition of Australia's growth would change - the housing sector was expected to weaken and the export sector expected to get stronger. At that time the Bank also indicated that the positive of this change was that exports comprise 20% of GDP and housing only 5%.[26] Since that time, the housing sector has contracted by over 35% in the six months to December 2000, which is the largest fall in 40 years of national accounts. The fall reduced growth by more than 2% over the second half of 2000, after contributing 1% to growth in first half of 2000.[27] This issue is outlined in more detail in the next section.

2.22 In addition to the substantial fall in housing investment which is discussed in detail later, there has been a weakening in consumer spending and some deferral of investment in the second half of 2000. At the May 2001 hearing, the Bank outlined several contributory factors which include the:

- rise in petrol prices;
- increase in interest burden of both household and business sectors from the interest rate rises in 1999 and 2000; and
- disruptions arising from the new tax arrangements and the Olympic Games.[28]

24 Evidence p 55.

25 Evidence pp 50-2; and *Statement on monetary policy May 2001* pp 5-6, 18.

26 Evidence p 9.

27 Evidence pp 56-7; and *Statement on monetary policy May 2001* p 17.

28 *Statement on monetary policy May 2001* p 17.

2.23 The manufacturing sector has also weakened during the second half of 2000, with the largest falls in those areas connected to the construction sector. The recreation and culture sectors have fallen significantly in the December quarter, though this is after the rise in the September quarter due to the Olympic Games.[29]

2.24 In response to the question whether the slowdown was the result of cyclical factors or a policy error, the Bank replied that:

> Everyone is having a cyclical slowdown. The thing that was different about us was that, instead of it being a slowdown, we had that negative quarter, and that negative quarter, I would say, was due to the transition effect of a basically sensible policy which had short-run costs.[30]

2.25 When asked whether there were any other major developing economies beside Australia to have negative economic growth in the December 2000 quarter, the Bank said it did not think so. It went on to say '…That was a peculiar Australian event and that is why there was so much surprise and disappointment…'[31]

2.26 On the positive side, net exports and accumulation of inventories contributed significantly to economic growth over the six months to December 2000. The external sector contributed 1% to GDP growth over the year to December 2000. This was as a result of strong world demand and a low Australian exchange rate. The Bank also expects that the current account deficit will fall below 3% of GDP from its peak in mid 1999 of 6% of GDP.[32]

2.27 The Bank was queried as to what happened to the tax cuts that were part of the new tax system. It replied that:

> …the tax cuts are still there. They were expansionary and even though more came in earlier in the year than was thought likely, we think that overall there will still be an expansionary influence from the tax cuts…[33]

2.28 The committee questioned the Bank about the impact of the economic reforms in Australia over the past two decades. The Bank was of the view that the reform process had increased Australia's level of productivity to such an extent that an annual growth rate of above 4% was achievable over the long-term. The Bank also said that Australia might not yet have

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29 *Statement on monetary policy May 2001* p 22.

30 Evidence p 68.

31 Evidence p 68.

32 *Statement on monetary policy May 2001* pp 17, 31.

33 Evidence p 64.

fully benefited from the effects of the new technologies, as has been the case for the US economy. Thus the additional associated productivity gains may '…still [be] in the pipeline…'[34]

2.29 The committee compares this with the Reserve Bank Governor's CEDA speech where the Governor comments that '…the willingness to adopt new technology is surely the key to improving productivity, and here there are a number of indicators that place Australia very high in the world rankings…'[35] The Governor explained that:

> Not surprisingly, we do not match the United States in most of these measures, but we are almost always in the top quartile or higher, suggesting that among OECD countries we should be regarded as being towards the top end of the range in willingness to embrace new technology.[36]

Housing sector

2.30 In the December 2000 quarter the housing sector fell, as a percentage of GDP, to its lowest level in 40 years, after achieving in the March 2000 quarter its highest level in 20 years. In the September 2000 quarter alone, private dwelling investment fell by more than 20%.[37] This was due to the bringing forward of dwelling investment prior to commencement of the GST.

2.31 Though a significant fall was expected, the extent of the decline was not.[38] The Governor said that:

> …If you had told me before the event that the fall in house building, a sector which accounts for only five per cent of the economy, would be large enough to outweigh reasonable growth in the other 95 per cent of the economy, I would not have believed you…[39]

34 Evidence p 67.

35 Macfarlane, I. December 2000. Recent influences on the exchange rate. Address given to the CEDA Annual General Meeting Dinner, Melbourne, 9 November 2000. *Reserve Bank of Australia Bulletin*. Sydney, RBA, p 5.

36 Macfarlane, I. December 2000. Recent influences on the exchange rate. Address given to the CEDA Annual General Meeting Dinner, Melbourne, 9 November 2000. *Reserve Bank of Australia Bulletin*. Sydney, RBA, p 5.

37 *Statement on monetary policy May 2001* p 20; and Reserve Bank of Australia. February 2001. *Statement on monetary policy February 2001*. Sydney, RBA, p 20.

38 Evidence p 61.

39 Evidence p 50.

2.32 The Bank admitted that:

> …we plead guilty to having got those figures wrong and we think you can explain the vast majority of it through that factor: we were dealing with a once in a lifetime or once in a generation change and we were not able to predict exactly what the outcomes would be…[40]

2.33 The Bank's analysis of the experiences of other countries that have introduced a GST did not lead it to expect that such a particular event, like an enormous fall in housing investment, would occur in Australia.[41]

2.34 The reasons, put forward by the Reserve Bank, for the very large fall are that:

- the introduction of the new tax system, particularly the GST, created an incentive to bring forward dwelling construction to before 1 July 2000. The Bank again reinforced that '…what we were witnessing was not the normal cyclical development of an economy but the transitional effects of a once-in-a-generation structural change to the tax system';[42] and
- the tightening of monetary policy during 1999 and 2000.[43]

2.35 The Bank noted that part of the reason why it underestimated the fall in housing was that the backlog of house building that did not get completed prior to the introduction of the GST was smaller than expected. The Governor said that:

> …in our discussions with the building industry they kept saying that there was a huge backlog still to be completed that did not get finished by 30 June … I am still surprised at how big a fall away there was, given that we all know there was a big backlog that had to be completed.[44]

2.36 In its February 2001 *Statement on monetary policy*, the Bank pointed out that:

> …in contrast to previous dwelling cycles, at this stage there is little evidence of a large oversupply of dwellings, which suggests that the downturn may not be as protracted as in the past. In addition, the prospects for a recovery in the dwelling sector have been bolstered by an increase in affordability in recent months as

40 Evidence p 57; and see also Evidence p 50.

41 Evidence pp 56-7.

42 Evidence p 50.

43 *Statement on monetary policy February 2001* p 21.

44 Evidence p 59.

> growth in house prices appears to have eased and as fixed home loan rates have declined.[45]

2.37 The Reserve Bank reported that recently, the Housing Industry Association and the banks have commented that house building '…is in the process of turning around and that its upswing could be very pronounced.'[46] The Bank also confirmed that it does not believe that the volatility in housing is signalling a return to a more volatile economic cycle.[47]

2.38 The Bank expects the combined effects of lower interest rates and the $14,000 grant for the purchase or construction of a new house will start to show up probably by the June quarter.[48] Already in the March 2001 quarter there has been an increase in construction of 2.4%.[49]

Consumer and business confidence

2.39 The committee again asked the Bank questions about the significant falls in consumer and business confidence over the past year. The Bank noted that consumer confidence stayed above its average level until March 2001.[50] The Bank expressed the view that the recent sharp falls in consumer confidence to levels below their long-term average were directly linked to the sharp contraction of GDP in the December quarter and the fall in the exchange rate to record lows.

2.40 In commenting on the contraction in GDP, especially in the housing sector, the Bank said '…the reaction was so large at that time that a number of commentators raised the possibility that the country could talk itself into a recession.'[51]

2.41 In commenting on the exchange rate it stated that:

> …when you already have a low exchange rate, further falls can be very unsettling, especially if they are accompanied by headlines about new lows being reached and new barriers being breached. People inevitably see this as a loss of international confidence in their country and they in turn lose confidence. The falling

45 *Statement on monetary policy February 2001* p 21.

46 Evidence p 52.

47 Evidence p 70.

48 Evidence p 59.

49 Australian Bureau of Statistics. 6 June 2001. *Australian National Accounts: National income, expenditure and product*, 16p.

50 Evidence p 54.

51 Evidence p 50.

> Australian dollar was widely cited reason by respondents to the consumer sentiment survey for why their confidence had fallen…[52]

2.42 At the December hearing the Reserve Bank agreed to undertake research into the factors that affect small business confidence. The Bank reported its findings in the *Statement on monetary policy May 2001*.[53] By way of background it highlighted that:

- small businesses account for 49% of total private sector employment, however they account for only 30% of sales and 39% of operating profit before tax;
- the construction, property and business services, and retail sectors comprise just under half of all small businesses; and
- small businesses make up 82% of the total employment in the construction sector, where as the mining sector is 12% and the finance and insurance sector is 20%.[54]

2.43 In terms of business confidence, there is a noticeable divide between small businesses and medium/large businesses. The ABS quarterly survey of business expectations reported a fall in confidence for large businesses over the past four quarters, though overall it is still positive.

2.44 However, there has been a more marked decrease in confidence for smaller businesses. The ABS survey predicted expected operating income to fall for each of the last four quarters, and the Yellow Pages survey of small businesses recorded small business confidence at its lowest level since the survey commenced in 1993. In relation to the Yellow Pages survey, the Bank said that:

> …The most commonly identified concern is a lack of work or sales. In part, this may reflect the small business sector's disproportionately large share in the construction, manufacturing and retail trade sectors. Output from these three industries fell by more than 7 per cent over the second half of 2000, compared with a rise of 2 per cent for other industries…[55]

2.45 The Bank was asked about the role the media played in consumer and investment confidence, and it responded that:

> Consumer confidence did dive after the December quarter national accounts were reported by the media, but it was not necessarily because of the way the media reported it. It may

52 Evidence p 52.

53 *Statement on monetary policy May 2001* pp 22-3 and Box A (pp 29-30).

54 *Statement on monetary policy May 2001* pp 29-30.

55 *Statement on monetary policy May 2001* p 23.

> simply have been because of the content that was contained therein, namely that there had been a fall in GDP in the December quarter. I do not think we can blame the media for the fact that the consumer confidence declined at that time.[56]

Impact of the new tax system

2.46 The committee asked the Bank whether administration of the new tax system has had a negative impact on confidence that has added to the economic slowdown? The Governor replied that, while he did not know the answer to that question, any change to the tax system of that magnitude is an enormous undertaking and requires a lot of adjustment from everyone. He believes that consumers seem to have adjusted well to the new arrangements and everything seems to be running quite smoothly, but business did not adjust as smoothly because of the extra work and inconvenience.[57]

2.47 A question was asked as to whether the new tax system has reduced profitability and thus added to the economic slowdown? The Governor responded that he does not think so, however, it takes time for price changes to be passed through to consumers and the increase in oil prices and the fall in the exchange rate blur the picture. The September and December quarter CPI figures did provide '…very general, tentative evidence that there might have been a squeeze on profitability in that at least three separate price effects had to be passed through…' The March quarter CPI figure increased the Bank's '…confidence that the sum of these three things was being passed through.'[58]

2.48 The Committee compared this with the Reserve Bank Deputy Governor's speech on 23 March 2001, where Dr Grenville highlighted that '…in a low-inflation world – where producers pass on price increases only with some trepidation – the threefold sources of pressure on prices (GST, exchange rate and oil) squeezed cash-flows and profits…'[59]

56 Evidence p 58.

57 Evidence p 61.

58 Evidence p 62.

59 Grenville, S. April 2001. The Australian Economy. Address given to the ABN AMRO Australia Day Conference, Tokyo, 23 March 2001. *Reserve Bank of Australia Bulletin.* Sydney, RBA, p 7.

Fiscal policy

2.49 Following on from the December hearing, the committee sought the Reserve Bank's views on the impact of an expansionary fiscal policy on monetary policy, which could result from a 'bidding war' in the lead up to next federal election. In response the Bank stated that:

> I think the answer to that is what sort of budget surplus or budget deficit or what sort of total budgetary position is the one that is appropriate for the present circumstances. The first thing is that, with a weaker economy than we assessed as having when I made that statement back in August last year, obviously a more expansionary stance of fiscal policy makes more sense now than it did back in August last year…[60]

2.50 The Bank pointed out that short-term initiatives, like the first homeowner's grant, which has a sunset clause, are '…not unreasonable policies.' However, where these policies are not counter-cyclical they may provide a stimulus to economic growth after the economy has recovered, increasing the likelihood of overheating the economy and affecting the overall structural budgetary position.[61]

2.51 Later the Reserve Bank went on to say that the budget should be ultimately judged by the final budgetary position, and that:

> …it would not be responsible to have a further major expansion of fiscal policy at the moment that pushed it significantly into the red. I think that a large deficit would be an overreaction.[62]

Exchange rate

2.52 On 3 April 2001 the Australian dollar reached a record all-time low to date during intra-day trading of US47.75¢ and 46.6 in trade-weighted terms. The Reserve Bank's explanation for the fall was that '…It was due to a bout of pessimism that was brought on by the December quarter national accounts, but that has since been reversed…'[63] On 6 March 2001, the day before the release of the national account data, the Australian dollar was US52.2¢ and 49.1 in trade weighted terms.[64]

60 Evidence p 70.
61 Evidence pp 70, 72.
62 Evidence p 72.
63 Evidence p 75.
64 Evidence p 52.

2.53 A major benefit from the low exchange rate has been the support it has provided to Australian exporters, with exports growing by more than 17% over the year to March 2001 quarter.[65] The current low level of the real exchange rate, in the Bank's opinion:

> …confers on Australian exporting and import-competing companies a significant price advantage over comparable foreign firms. These conditions are supportive of continued strong growth in the traded sector of the economy.[66]

2.54 However, the Reserve Bank emphasised that a low exchange rate has had an unsettling effect on consumer and business confidence. It said, people see it as a vote of no confidence in the Australian economy.[67] The Bank said that:

> …once it is already low and you are confident that it is making your industries very competitive it is not at all clear that you are getting any value at all out of it falling further because the effects on confidence may be more damaging than the gains that industry gets from it.[68]

2.55 In response to the question about why the Australian dollar was so weak, the Reserve Bank commented that it was unable to explain either the weakness in the Australian dollar, nor the strength in the US dollar which is even more difficult to explain.[69] For the US dollar, many of the factors previously used to explain its strength have moved in the opposite direction, for example, the US economic outlook, equity prices and interest rate differentials.[70]

2.56 During May 2001, the exchange rate appreciated to over US52¢ and when asked whether the Australian dollar was still well below its fair value, the Reserve Bank agreed but did not specify a particular level.[71]

2.57 The committee asked the Bank whether it believed that the nexus between commodity prices and the Australian dollar had been broken. The Bank agreed and said that the recent fall in the Australian dollar was not consistent with the usually influential factors like principally commodity prices.[72]

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65 *Statement on monetary policy May 2001* p 31.

66 *Statement on monetary policy May 2001* p 43.

67 Evidence p 52.

68 Evidence p 60.

69 Evidence p 74.

70 *Statement on monetary policy May 2001* p 13.

71 Evidence p 75.

72 Evidence p 83.

Interest rates, inflation and monetary policy

2.58 Since the December hearing, there has been a significant shift in the Reserve Bank's stance on monetary policy. From February to April 2001, the Reserve Bank decreased rates three times by a total of 125 basis points or 1.25% and returned monetary policy to an expansionary setting. The Bank stated that:

> …Collectively, this represented an uncharacteristically large move and therefore deserved some explanation. Basically, we realised, in view of the two preceding events, that a significantly lower level of real interest rates was required so that the stance for monetary policy would be clearly expansionary in that it would be supportive of economic activity.[73]

2.59 During the hearing, there was some debate as to what is expansionary or is not expansionary. On this issue the Governor explained that:

> …I think the simple way of answering that is really in terms of real interest rates compared with what you would judge to be some sort of rough neutral level – a neutral level based on what real interest rate have been during the average of the low inflation period; that is, since about 1992…[74]

2.60 The easings were 'front-loaded' and shifted interest rates to a level close to the low points reached in the previous two monetary cycles. The April decrease was 50 basis points and larger than some people expected in an effort to foster confidence.[75]

2.61 The decrease was more rapid than the previous period of easing in 1996-97, but was '…less than the reduction in the US rates, but more than in other English-speaking countries…'[76] The Bank said that the reason for rapid decrease in rates compared to other English speaking countries was because '…this housing fall brought forward our cycle; it made it occur a bit quicker than it would have otherwise occurred.'[77] As well, the drop in rates was less than that in the US because the Australian economy does not have the weaknesses currently shown by the US economy.[78]

2.62 On the domestic side, the Bank said that:

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73 Evidence p 51.

74 Evidence p 66.

75 Evidence p 53.

76 *Statement on monetary policy May 2001* p 41.

77 Evidence p 66.

78 Evidence p 49.

> …the unexpected weakness of the housing sector, its effects on manufacturing and the deterioration in business and consumer confidence became clearer. The possible effects on spending of this decline in confidence posed the risk of more persistent weakness in demand even after the housing downswing finished.'[79]

2.63 With low inflationary expectations and inflation remaining well within the target range of 2% to 3%, the Bank has been able to aggressively reduce interest rates. After factoring in the effects of the new tax system and petrol price movements, underlying inflation has changed little since May 2000.[80]

2.64 The March 2001 quarter CPI figure was higher than expected indicating businesses may be rebuilding their profit margins after the introduction of the new tax system, higher import costs and higher oil prices. It is not likely however that these increases will:

> …seriously threaten the inflation target, as the current period of weak growth in aggregate demand should help limit the degree to which businesses will be able to raise prices.'[81]

2.65 The Reserve Bank was questioned about whether it erred in raising interest rates during 2000 when the economy was actually contracting. The Bank responded that its starting point of 4.75% was in its view an expansionary setting for monetary policy. During the period after the Asian crisis, the Australian economy performed better than forecast with growth of over 4.5% per annum for three years. With three known factors (the new tax system, a low exchange rate and higher oil prices) likely to create inflationary pressures, the Reserve stated that:

> …Our view was that the balance of risks at that time was in the inflationary direction and the safest course of action was to move from an expansionary setting of monetary policy to a neutral one and then to one that was slightly tighter than neutral … I think we made the right decisions on the information that was available at the time.[82]

2.66 The Bank pointed out that '…we know the path that the economy actually took but we do not know the path the economy would have taken if there

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79 *Statement on monetary policy May 2001* pp 2-3.

80 *Statement on monetary policy May 2001* p 44.

81 *Statement on monetary policy May 2001* p 50.

82 Evidence p 64.

had been no increases in interest rates…'[83] At various times at the hearing it also noted that:

- if the Bank did not increase interest rates during 2000 '…The exchange rate reaction would have been so overwhelming that you would have been forced into raising interest rates somewhat…'[84];
- the rise was the smallest tightening of monetary policy since the inception of the Reserve Bank[85];
- total household credit grew strongly during 2000 and continued to exceed the growth of household income; and
- asset prices, especially the Australian equities market, were relatively unaffected by the interest rate rises.[86]

2.67 The committee notes that the Reserve Bank has had an outstanding record on monetary policy since the early 1990s, but with hindsight the Bank's judgement could be questioned. It was a simple fact of misinterpreting the extent of the economic slowdown. When big structural changes, such as the new tax system, impact on small business, business confidence should be looked at closely by the Bank. At the Wagga Wagga hearing, the committee raised concerns about the sharp decline in business confidence figures in 2000. It would appear that the decline should have been more seriously addressed by the Bank.

Recommendation 1

2.68 **The committee recommends that in the future conduct of monetary policy when there is a major structural change in economic policy, the Bank should give appropriate weight to examining business confidence data.**

2.69 The Bank also stressed that the changes in monetary policy have been small and if the evidence changes you can always move interest rates quickly and take away any element of the tightening you have put in.[87]

2.70 In response to a question about whether the Bank should be less interventionist and leave demand management to fiscal policy, the Bank pointed out that: the dramatic moves in interest rates seen in previous decades have not occurred during the 1990s; and over the past decade the

83 Evidence p 64.
84 Evidence p 65.
85 Evidence p 65.
86 Evidence pp 64-5; and *Statement on monetary policy May 2001* p 19.
87 Evidence p 65.

Bank had become less interventionist than in the 1970s and 1980s and less inclined to move interest rates than other central banks.[88]

2.71 At the December 2000 hearing the committee asked the Bank its views on the appropriateness of Australian Bureau of Statistics (ABS) not sampling regional areas when calculating the CPI.[89] In its report from the December hearing, the committee recommended that the ABS investigate methods for ensuring that the sample includes regional areas.[90] **To date there has not been a government response to that recommendation.**

2.72 Following on from the issues raised at the December hearing, the committee asked the Bank whether it had any concerns regarding the measurement by the ABS of CPI and economic growth. The Reserve Bank indicated that it would prefer to gain a better understanding of economic growth outside capital cities. It said that '…there are obviously significant differences in growth rates between States and between regions within State…[and] the variation in growth rates is much greater than the variation in inflation…'[91]

2.73 The committee shares the Reserve Bank's concerns but doesn't resile from its recommendation on the CPI in its February 2001 report.

Prospects for 2001-02

2.74 As previously outlined, the Reserve Bank stressed that the speed and extent of any recovery in the Australian economy will primarily depend on international conditions, chiefly in the US. It expects the US economy to have a moderate economic slowdown or a 'soft landing', but is aware that a great deal of uncertainty surrounds the outlook for the US economy. A major risk is that the fall in investment spending may be much larger than anticipated, especially '…because of the excesses that preceded it.'[92]

2.75 On the domestic side, the Reserve Bank has projected economic growth to rise strongly in 2001-02 to between 3% and 3.5%, rising from a revised growth rate for 2000-01 of around 2%.

88 Evidence pp 70-1.

89 Evidence pp 21-2.

90 House of Representatives Standing Committee on Economics, Finance and Public Administration. February 2001. *Review of the Reserve Bank of Australia Annual Report 1999-00 Interim report: the Wagga Wagga Hearing.* Canberra, CanPrint Communications Pty Ltd, p 18.

91 Evidence p 69.

92 Evidence pp 52-3, 55-6.

2.76 In the short-term, capital investment in machinery and equipment is expected to increase modestly, though after a 5.5% fall in the December quarter. For 2001-02, the ABS Capital Expenditure Survey predicts that it will show a marked rebound especially in the utilities, property and business services, communications and mining sectors.[93]

2.77 The Bank forecast that unemployment is likely to increase further in the months ahead, in response to a slowing economy. However, although employment prospects are low by the standards of recent years, the Bank commented that '…at present they are considerably more buoyant than those prevailing immediately prior to the early-1990s recession.'[94]

2.78 Long-term interest rates give some cause for optimism. The Bank reported that long-term rates are some 100 basis points above short-term rates and said:

> …This appears to reflect a collective view among market participants that the uncertainties surrounding the economic outlook are starting to abate…[95]

2.79 The Bank noted that interest rates are now close to the low points reached in the two most recent episodes of monetary policy easing.[96]

2.80 The Reserve Bank's view on inflation was that it would be around 2.5% for 2001 and possibly rise slightly over 2002 to around 3%. Over the longer-term, inflation is expected to be subdued as a result of weak domestic and international demand growth.[97] There is a risk that the low Australian exchange rate may exert upward price pressure faster than envisaged boosting inflation in the year ahead. This would be more likely if the economy returns to strong growth relatively quickly, however this may cause the exchange rate to appreciate alleviating the price pressure.[98] In making these statements however, the Bank agreed that it is cautious.[99]

2.81 Inflation expectations also have been subdued.[100]

2.82 With the current monetary policy setting likely to assist growth and the economy and financial markets showing some promising signs, the Bank believes that:

93 *Statement on monetary policy May 2001* p 24.
94 *Statement on monetary policy May 2001* p 28; and see Evidence p 86.
95 *Statement on monetary policy May 2001* p 42.
96 Evidence p 53.
97 Evidence p 51.
98 *Statement on monetary policy May 2001* p 50.
99 Evidence p 55.
100 *Statement on monetary policy May 2001* p 50.

> …there is a reasonable chance that the current stance of policy will turn out to be easy enough to achieve the desired results.
>
> But equally, while it is reasonable to expect that the promising trends of late will develop into stronger momentum for growth, we cannot as yet be confident. This in turn means that we cannot be sure that further monetary policy easings will not be required.[101]

2.83 With Australia so dependent on the US economy, the committee can only hope the Reserve Bank is right and that the optimistic path is the one that the US ends up following.

2.84 The March national accounts figures were released recently and showed that in volume terms GDP increased by 1.1% in the March quarter.[102] Recent surveys have shown a pick-up in both business and consumer confidence.

2.85 The committee noted at the May hearing that the Bank took '…a very cautious approach to making any forecasts after recent experiences…'[103] The committee asked the Bank whether it continued to have confidence in its and Treasury's forecasting. The Governor responded:

> No more and no less than it has always been. Economic forecasting is a very imperfect art – I would not use the word 'science'. It, by and large, has not improved in 30 years. I have been through all the various attempts to improve it – all the large econometric models, the small econometric models, the leading indicators, all the surveys of expectations – and basically it is about the same as it always was.[104]

2.86 Expanding upon this, the Bank said that an approach is needed that can cope with imperfect forecasting rather than attempting to improve the accuracy of the forecast. The Bank explained:

> The question … is what is the most productive approach? Is it to throw massive amounts of resources into trying to get better forecasts, or is it to design a system which is relatively stable in face of the fact that forecasts will turn out to be wrong? I think the latter is a much more productive approach.[105]

101 Evidence p 53.

102 Australian Bureau of Statistics. 6 June 2001. *Australian National Accounts: National income, expenditure and product*, pp 1-2.

103 Evidence p 53.

104 Evidence pp 57-8.

105 Evidence p 58.

2.87 The Bank noted that this approach has been made easier by a low inflation environment, as in general the economy is more stable and policy does not need to respond as quickly. To illustrate the point, the Bank said that '…In the period we are talking about, the rise and fall of interest rates is the smallest cycle we have ever had…'[106]

2.88 The committee is coming to the view that some sectors of the Australian financial markets and commentators are placing undue emphasis and weight on the accuracy of short term forecasts.

106 Evidence p 58.

3

Other matters

Transparency and accountability

Composition of the Board

3.1 Section 14 of the *Reserve Bank of Australia Act 1959*[1] sets out the membership of the board of the Reserve Bank. There are nine members, with two Reserve Bank representatives, the Secretary to the Department of the Treasury, and six external members appointed in writing by the Governor-General. The members of the board are part time.

3.2 Since the last hearing, there has been some public discussion about possible reform and changes to the structure of the board of the Bank, largely arising from media comments made by Professor Adrian Pagan, a former board member. He proposed that three members of the board should be chosen with monetary policy expertise, as opposed to only two when Professor Pagan was on the board.

3.3 The Governor responded:

> Professor Pagan's views on the appropriate governance arrangements for a central bank are very heavily influenced by the Bank of England…I think we have to be a little sceptical at this stage on the Bank of England model for several reasons. We must remember that the UK was the last country to adopt the principle of central bank independence. Being the last one to do it, they have come up with a model which I think shows the usual zealousness of the recent convert. The Bank of England model has a board which basically consists of professors of economics, so it is

1 *Reserve Bank of Australia Act 1959*, Section 14, p 11.

> not at all surprising that a professor of economics is very much in favour of that model…There are some strengths in such a model in that it does mean that the board members are going to be well-educated in monetary economics. The argument against it, from broad democratic principles, is that it means you have a board which is not really very representative of the country - it does not represent a whole lot of different experiences or approaches. It basically means that you add another four monetary economists to the three monetary economists who are already on the board. So you have more expertise but you have it drawn from a very narrow range of possible disciplines.[2]

3.4 In summary, the Bank regarded the current composition of its board as a genuine external board that is part-time and '(arguably) has the most democratic legitimacy', and is working well.[3]

Role of the Board

3.5 Professor Pagan has described the current board as being reactive and having a monitoring or reviewing role.[4] He believes that three external board members should be chosen for their ability to deliver an opinion on monetary policy proposals backed by reasoned argument. Their role should be not only that of reviewing policy proposals. They should be capable of and willing to mount an alternative case to that presented by the Bank and thus allow the board to be more proactive.[5]

3.6 In response to Professor Pagan's public comments, the Bank suggested that the danger of the British system is that everyone has the same intellectual background, whereas that is not the situation in Australia. The mere diversity of the board members means there are valued contributions with the assessment of the economy. The Bank said:

> It is true to say that (all board members) would not understand the sort of simulation exercise or model building that Professor Pagan does, but that does not mean that they are not contributing to monetary policy or to our assessment of the economy.[6]

2 Evidence pp 75-6.

3 Evidence p 76.

4 Pagan, A. Bring on the fresh Reserves. *Daily Telegraph*, 9 January 2001.

5 Pagan, A. Bring on the fresh Reserves. *Daily Telegraph*, 9 January 2001.

6 Evidence p 77.

3.7 The Bank maintained that, from time to time, some external board members have spent time in the Bank's research department discussing and arguing things with economists, and the door is always open for this.

3.8 Despite some suggestions to the contrary, the Bank claimed that with the present board composition, there was some challenging discussion taking place that also allowed scope for board members to raise proposals as well as just reacting to information the Bank representatives provided.

3.9 The committee asked if board members had enough research capacity available to effectively challenge the recommendations that might be brought to the board meetings by the Bank. In the media, it had been suggested that only one board member had that capability, that is, the Secretary of the Treasury.[7]

3.10 The Bank responded that board members are able to request special papers on specific issues. They do get additional information that they initiate, as well as the information the Bank gives them. 'They get a massive amount of material…'[8]

Transparency of Board activities

3.11 The Bank advised that they continue to be under intense public scrutiny[9], with daily media stories, twice-yearly appearances before the committee, and some pressures to provide information after each board meeting.

3.12 Currently both the US and UK central banks release their board minutes. While this does not occur in Australia, the Bank advised that most of the information being provided to board members, prior to board meetings, is the information that appears later in the published quarterly statement on monetary policy - it would not be received as one document, but as several papers, and would include similar sorts of material.[10]

3.13 The Bank stated that the quarterly statement produced after the relevant board meeting, bears a very strong resemblance to the material prepared before the board meeting. It is similar, but updated.[11]

3.14 When there are changes in monetary policy the Bank puts out a statement on this. However, when asked about providing a statement after board meetings where no change is made, the Bank said that it did not favour that course:

7 Pagan, A. Bring on the fresh Reserves. *Daily Telegraph*, 9 January 2001.

8 Evidence p 77.

9 Evidence pp 76-7.

10 Evidence p 78.

11 Evidence p 78.

> …sometimes you can go for 18 months without making a move and, if at every meeting you have to give an explanation, you run the risk that everyone will compare what you said this month with last month. It concentrates everyone on short-term monthly data… to understand the economy and the role of monetary policy, you have to have got to look at a much longer horizon.[12]

The Bank noted that there are not many people who are currently paid or engaged in taking a long term view.[13]

3.15 The committee shares this concern and feels the short term approach of so many in today's financial markets could run the risk of declining private investment in long term projects. The committee will ask the Bank for a more considered view on this issue.

Summary

3.16 At the hearing, a few comments of comparison were given on the different central bank structures that have different attractive features. The Reserve Bank said it imagined that the British press would regard the new Bank of England as the 'first best', but the Reserve Bank said it probably regarded the US Federal Reserve as the one to emulate, if we had such a massive economy. Germany is in a similar position. The structure of the Bundesbank is like the US Fed structure, which is probably the best structure. If picking various features from different structures and putting them together, it is not clear that they would coexist at all well. The choice is really whether you want expertise or breadth.[14]

3.17 While the US model has been described by the Reserve Bank as 'first best', it noted that the US Fed serves a massive economy and Australia is not in a position to have that system with massive regional central banks.

3.18 The Reserve Bank said that its current board is very representative of the country, while also having the expertise of money economists, and all members having access to the Bank's research resources. The Bank advised '…that the current system works well enough not to require legislative change.'[15]

3.19 The committee acknowledges that none of the central banks around the world have the ideal framework, as each has strengths and weaknesses. The question then is whether Australia's system is working well.

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12 Evidence pp 79-80.

13 Evidence p 79.

14 Evidence p 76.

15 Evidence p 76.

3.20 Australia has part-time board members, who represent the business and community sectors. The committee accepts that, the board believes with this reasonable balance, there is a very good decision-making foundation and the system has worked well. The committee will review the matter further at a future meeting with the Bank.

3.21 While the media, academia and some financial market commentators will always want more information, the committee considers the present distribution of information also is effective. The twice-yearly public appearances by the Bank continue to be a major part of the transparency of its decision making and an important part of its accountability to Parliament. However, the committee will continue to monitor opinion and developments on transparency.

Developments from the interchange fee study

3.22 In October 2000, the Reserve Bank and the Australian Competition and Consumer Commission (ACCC) released a joint study into interchange fees for debit and credit cards.[16] The report was discussed in-depth at the December 2000 hearing. At that time, the ACCC was pursuing an authorisation process under the *Trade Practices Act 1974* for the credit card systems of Visa, MasterCard and Bankcard.[17]

3.23 Since then, the ACCC found that the major banks were unwilling to '…embrace substantial reform on key issues ' and in March 2001 the ACCC recommended that the Reserve Bank use its legislative powers under the *Payment Systems (Regulation) Act 1998* to reform credit card schemes. The ACCC was of '…the view that the Reserve Bank by way of its legislative powers could progress the issue in a manner which is likely to provide greater public benefits' and '…in the most timely and effective manner.'[18]

3.24 In April 2001 the Payments System Board 'designated' the credit card systems operated in Australia by Bankcard, MasterCard and Visa as payment systems subject to regulation under the *Payment Systems (Regulation) Act 1998*.[19] This is the first occasion that the Reserve Bank's

16 Reserve Bank of Australia and Australian Competition and Consumer Commission. October 2000. *Debit and credit card schemes in Australia: A study of interchange fees and access.* Sydney, RBA, 82p.

17 Evidence p 80; and RBA and ACCC p 5.

18 Australian Competition and Consumer Commission. *ACCC Recommends Reserve Bank Consider Using Powers to Reform Credit Card Schemes.* Media Release, 21 March 2001, 4p.

19 Reserve Bank of Australia. *Designation of credit card schemes in Australia.* Media Release, 12 April 2001, 2p.

powers in this area have been used and tested. At the May 2001 hearing the Bank said the next step in the process is for it to establish standards for setting interchange fees and a regime for access to the credit card systems. The process will involve extensive consultation leading to the publication of a consultation document that will explain the public interest issues and outline the Bank's proposed standards and access regime.

3.25 At the outset of the discussion into interchange fees the Bank stressed that interchange fees is a complex issue because of all the cross-subsidies involved and that it takes time to come to grips with the system.

3.26 At the hearing, while pleased with the progress being made with credit card interchange fees, the committee expressed concern about progress with the mark-up in ATM fees (of the order of 175%) and EFTPOS fees (with a 23% mark-up).[20] The committee stated that ATMs and EFTPOS were a major concern in the initial study, are of significant concern to consumers, and that there is scope for improvement in the total system (both credit cards and ATMs and EFTPOS) systematically so that there was not a distortion of the market.[21]

3.27 The Reserve Bank responded that while making comments on ATMs and EFTPOS in its initial report, the focus was on credit cards. The reasons the Bank gave for its decision to make credit cards the priority were:

- credit cards are a more expensive way of providing payment services than EFTPOS and were growing more rapidly than EFTPOS;
- '…the ACCC found there was a per se case of price fixing…'[22] in relation to Visa, MasterCard and Bankcard whereas with ATMs and EFTPOS, each bank negotiates bilateral arrangements with each of the other banks;
- the banks were not really cooperating in seeking a solution on credit cards whereas some action is already underway with ATMs. Some banks have agreed that foreign ATM fees are too high and are discussing with other banks ways of addressing this; and
- the Reserve Bank's belief that it was better to investigate credit cards thoroughly and in order, rather than try to do all three at the same time.[23]

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20 Reserve Bank of Australia and Australian Competition and Consumer Commission. October 2000. *Debit and credit card schemes in Australia: A study of interchange fees and access.* Sydney, RBA, p 66.

21 Evidence pp 80-1.

22 Evidence p 80.

23 Evidence pp 80-2.

3.28 The Bank also noted that the big losers with credit cards are: poorer people who do not have a credit card; poorer people who have a credit card but because of their circumstances find themselves having to borrow on the revolving line of credit; and retailers who pay the merchants service fees. It also noted that there may be greater community concern about EFTPOS and ATMs because it is easier, and more obvious, to see the distortion whereas with credit cards the distortion is more complex.[24]

3.29 The Bank also advised that it will undertake further work on EFTPOS and ATMs when the credit card investigation is completed later this year. It expects work on the ATMs and EFTPOS will commence next year.[25]

3.30 The committee does not consider that the Reserve Bank has achieved the right balance on this issue because of the reasons the committee outlined earlier. Accordingly, the committee is seeking earlier progress on the ATMs and EFTPOS investigations than the Reserve Bank currently has outlined.

3.31 The committee was also concerned that the Bank's credit card work might squeeze out credit unions and building societies. In response the Bank explained that it was not in the public interest to have more competition where it is only possible through higher prices for consumers. It considered that:

> …firstly, the credit unions and the building societies will be able to survive and, secondly they will also be able to remain in that business even if interchange fees were lower.[26]

3.32 At the hearing, the committee also asked whether the Bank was confident that the savings from the changes the Bank is seeking with credit cards would deliver significant gains for consumers, particularly by large retailers. The Bank replied that it was confident that this would occur because the current trading conditions are very competitive, with businesses finding it difficult to pass on costs.[27]

3.33 The issue of loyalty programs was raised, with the committee particularly asking about how these programs are funded. The Bank noted that these schemes only commenced about five years ago in 1995-96. The Bank stated that funding is through a higher interchange fee than would otherwise exist. This in turn results in an increased retail price. The Bank went on to say that:

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24 Evidence p 81.

25 Evidence p 81.

26 Evidence p 83.

27 Evidence p 82.

> …The sum of those sums of money is sufficient and so generous that they can discount and they can use that flow of money to provide loyalty points to cardholders.[28]

3.34 The Bank stated that the credit card is an efficient payments instrument and that people would continue to use it even if there were no loyalty points, as they did before the loyalty schemes were introduced.[29]

3.35 The committee continues to be concerned about credit card loyalty programs and will be closely monitoring this issue.

Recommendation 2

3.36 **The committee recommends that the Reserve Bank gives the same priority to investigate ATMs and EFTPOS fees, including loyalty programs, as it gives to credit card fees.**

RBA State offices

3.37 At the December 2000 hearing the Reserve Bank outlined a new initiative to gather additional economic intelligence by establishing regional offices in each State. Each office consists of two economists and a back office. New offices were established in Brisbane, Perth and Melbourne, with the Melbourne office also covering Tasmania. For the other state capitals, the Bank's existing premises are used to house the new offices.[30]

3.38 In its update to the committee on progress in establishing the new regional office structure, the Bank stated that:

> …the Melbourne, Perth and Brisbane ones have been established. We have very good people to staff them. They are working very well and enthusiastically … we are very happy with the way it is going.[31]

3.39 The major improvement from the new system is that:

> …They are actually members of his [Assistant Governor (Economic)] staff. Even though they are remote from his department they report directly to his department, which is a big improvement on what we had before when we had an economist in each State but they reported to the manager of the State. The

28 Evidence p 82.

29 Evidence p 83.

30 Evidence p 28.

31 Evidence p 74.

> manager was really a banker whose main expertise was in providing banking services to government departments...[32]

3.40 The Bank also pointed out that they have held board meetings in two of these offices - Perth and Melbourne - since those offices were established.[33]

3.41 The committee welcomes the Reserve Bank board's activities to gather more Australian-wide information for economic analysis. The success of this initiative will no doubt be reflected in the Bank's future performance on State and regional issues.

Resources

3.42 Given the committee's past concerns about the adequacy of staffing and resources of the Australian Prudential Regulation Authority (APRA), the committee also queried the adequacy of the Reserve Bank's resources situation.

3.43 The Governor stated:

> I think we are adequately resourced to do the job because it is our decision. We do not have to go cap in hand to anyone and ask for an appropriation. We make the decision ourselves as to what we think is the appropriate level of resources and so we are at what we think is the optimal level. It is always a struggle to keep the best people…we win on enough occasions to keep up the standard…we cannot complain that we are short of resources.[34]

3.44 The committee can only note the luxury of such a resourcing framework compared with most public sector organisations.

Prudential supervision of the insurance and superannuation industries

3.45 In March 1997, the Financial System Inquiry recommended that a single regulator be established for the prudential supervision of the deposit-taking institutions, superannuation and insurance industries rather than the separate regulators that existed at that time.[35] In July 1998 under the *Australian Prudential Regulation Authority Act 1997*, APRA was established

32 Evidence p 74.
33 Evidence p 74.
34 Evidence p 79.
35 *Financial System Inquiry final report*. March 1997. Canberra, AGPS, xv 771p.

to regulate all of those industries and it gradually assumed full responsibility for those areas. Whereas the Reserve Bank previously managed bank prudential regulation, it now has responsibility for the overall stability of the financial system. As a result of that responsibility, the Reserve Bank has two seats on the APRA board - one held by the Governor of the Bank and the other held by the Assistant Governor (Financial Services).

3.46 At the May hearing, the Reserve Bank was asked several questions relating to the collapse of HIH Insurance, which is supervised by APRA. The Bank stressed that it is only involved in this issue because of its responsibility for the overall financial system stability and its consequent seats on the APRA board.[36]

3.47 The Governor stated that the Reserve Bank has considerable expertise in bank supervision but it '…does not know much about insurance supervision…'[37] He pointed out the difference in the standards of supervision of different types of financial institutions, noting the very high standard of supervision of banks and other deposit-taking institutions (like building societies and credit unions) and that of the life insurance industry. The Bank said legislation to regulate both of those sectors has been updated recently, in 1998 and 1995 respectively, following crises in both sectors.

3.48 The Bank said that:

> When we move to general insurance we really have to come down from that level. We are dealing with a piece of legislation that is pretty old – it dates from 1973 – and an awful lot of changes have occurred since then…[38]

3.49 The Bank reported that the Insurance and Superannuation Commission, the predecessor of APRA, and now APRA have:

> …tried extremely hard to update that legislation and body of regulations, and they have met with considerable opposition from the industry - a degree of opposition that has surprised me, considering my experience with the banking industry…
>
> APRA has already worked out what the regulations should be. They have had all the discussion papers and they have got a new model. They are just waiting for the legislation…it is not just HIH but GIO.[39]

36 Evidence p 83.

37 Evidence p 83.

38 Evidence pp 83-4.

39 Evidence p 84.

3.50 The Bank also offered comments on several issues relating to superannuation. It stated that:

> …in superannuation the public's expectation of what APRA can do and what APRA actually have the powers and resources to do are very different things.[40]

3.51 It explained that in superannuation there are three different areas:

- the big public-offer funds and industry funds which the Bank thinks are in good shape;
- the very small one person (private superannuation) or funds of five or fewer people which usually involve family funds that comply with tax laws and there are no problems with them; and
- the intermediate group of small self-managed superannuation funds of more than five people and they report to APRA and there are difficulties.

3.52 The Bank said that with the intermediate group:

> …The problem is that there are about 10,000 of them. The majority, of course, would no doubt be extremely well run, but there will always be a fringe that are not, and it is extremely difficult to identify where that fringe is, because the numbers are so huge. There is no licensing requirement or capital requirement. They have to submit an annual return six months after the end of the year or so. APRA can look at the return, but that does not necessarily tell you what the underlying assets are.
>
> A couple of recent cases have attracted attention. These smaller funds are often company based. They might have 20, 50 or 100 people in them. There have been cases where, obviously, some very irresponsible financial transactions and related-party transactions have taken place. The public has a right to think that that should not happen, because, if you were a member of that fund, you could lose your life savings. There is a public expectation that that should not happen – and I entirely agree with the public expectation that that should not happen – but, with the resources that APRA has, it cannot make an inspection of each fund every year; it would be physically impossible.[41]

3.53 These requirements make it very hard for APRA to determine where the trustees are not acting in the best interests of the members. The Bank suggested that:

40 Evidence p 84.

41 Evidence p 85.

> …Somehow or other, we have to find a way of reducing the number of them by imposing some licensing standards, some capital requirements and what have you – either that, or just find a massive amount of new resources for APRA.[42]

3.54 Like some others in the community, the committee has concerns about the performance of APRA regarding both general insurance and the intermediate superannuation funds. This was to some extent reflected in the committee's report on APRA tabled last year.[43] However, the committee notes that, during that investigation, APRA did not stress the imperative for legislative change in what was an ideal parliamentary opportunity for it to do so.

3.55 The committee welcomes the Government's establishment of a Royal Commission into the collapse of HIH and pending legislative changes to general insurance. As the committee has a standing reference on APRA from the Minister for Financial Services, as well as the option of reviewing APRA's annual report on an annual basis and has recently picked up an Auditor-General's report on APRA's prudential regulation of the banks[44], the committee is considering further work on APRA's performance.

Cheque clearing cycle

3.56 In its Payments System Board annual report and at several previous hearings, the Reserve Bank has provided updated information on progress with the three-day cheque clearing cycle. At this hearing a committee member asked the following question, at the suggestion of one of the school groups present - ‘Why does it take three days to clear a cheque?’

3.57 The Bank responded that it takes three days because the process involves an exchange of paper, plus the checking process involves three steps, namely: that the cheque is valid; there are funds in the account; and that it is the right signatory. Relatively recently, some Banks have reduced clearance from five to three days. [45]

3.58 In the future, if clearance is done more electronically through ‘cheque truncation’, then that will be much quicker. However, the Bank noted that it would take a substantial capital investment for the industry to do that. With the use of electronic techniques the period of clearance has been

42 Evidence p 85.

43 House of Representatives Standing Committee on Economics Finance and Public Administration. October 2000. *Review of the Australian Prudential Regulation Authority: Who will guard the guardians?* Canberra, CanPrint Communications Pty Ltd, xiv 47p.

44 Australian National Audit Office. May 2001. *Bank Prudential Supervision: Australian Prudential Regulation Authority*. Audit Report No. 42 2000-01. Canberra, ANAO, 112p.

45 *Payments System Board annual report 2000* p 28.

substantially cut down and that has been a big step forward. In time, it should continue to decrease but quite a lot of technology would be involved.[46]

3.59 As some of the banks still have not achieved the three day standard, the committee will continue to monitor this matter.

David Hawker MP
Chair
18 June 2001

46 Evidence p 85.

A

Appendix A – List of hearings, briefings and witnesses

Public hearings

Friday, 11 May 2001 – Melbourne

Reserve Bank of Australia

Mr Ian Macfarlane, Governor

Mr Richard Battellino, Assistant Governor (Financial Markets)

Dr John Laker, Assistant Governor (Financial System)

Mr Glenn Stevens, Assistant Governor (Economic)

Friday, 1 December 2000 – Wagga Wagga

Reserve Bank of Australia

Mr Ian Macfarlane, Governor

Dr John Laker, Assistant Governor (Financial System)

Mr Glenn Stevens, Assistant Governor (Economic)

Private briefings

Tuesday, 1 May 2001 – Sydney

Mr Richard Gibbs, Head of Economics, Macquarie Bank Limited

Mr Bill Shields, Chief Economist, Macquarie Bank Limited

Thursday, 5 April 2001 – Canberra

Dr Ron Silberberg, Managing Director, Housing Industry Association

Wednesday, 4 April 2001 - Canberra

Dr Steven Kates, Chief Economist, Australian Chamber of Commerce and Industry

Wednesday, 28 March 2001 - Canberra

Professor Adrian Pagan, Professor of Economics at the Australian National University, and former board member of the Reserve Bank of Australia.

Monday, 27 November 2000 - Canberra

Dr John Edwards, Chief Economist, Hong Kong-Shanghi Banking Corporation

Dr Steven Kates, Chief Economist, Australian Chamber of Commerce and Industry

Thursday, 9 November 2000 - Canberra

Mr Chris Richardson, Chief Economist, Access Economics

B

Appendix B – List of exhibits

Exhibit No.	Organisation
1	Reserve Bank of Australia. Opening Statement to House Economics Committee's public hearing with the Reserve Bank of Australia, 11 May 2001, Melbourne, 6p.