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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2001-02

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 6 June 2003

Members: Mr Hawker *(Chair)*, Mr Albanese, Ms Burke, Mr Cox, Ms Gambaro, Mr Griffin, Mr Peter King, Mr Nairn, Mr Somlyay and Dr Southcott

Members in attendance: Mr Albanese, Ms Burke, Mr Cox, Ms Gambaro, Mr Hawker, Mr Nairn and Dr Southcott

Terms of reference: Review of the Reserve Bank of Australia's annual report 2001-02

WITNESSES

BATTELLINO, Mr Richard, Assistant Governor (Financial Markets), Reserve Bank of Australia 41

EDEY, Dr Malcolm, Assistant Governor (Economic), Reserve Bank of Australia 41

MACFARLANE, Mr Ian, Governor, Reserve Bank of Australia....................41

STEVENS, Mr Glenn, Deputy Governor, Reserve Bank of Australia 41

Committee met at 10.03 a.m.

BATTELLINO, Mr Richard, Assistant Governor (Financial Markets), Reserve Bank of Australia

EDEY, Dr Malcolm, Assistant Governor (Economic), Reserve Bank of Australia

MACFARLANE, Mr Ian, Governor, Reserve Bank of Australia

STEVENS, Mr Glenn, Deputy Governor, Reserve Bank of Australia

CHAIR—I declare open this hearing of the House of Representatives Economics, Finance and Public Administration Committee, and welcome representatives of the Reserve Bank, students and staff from Melbourne University and secondary schools, members of the public and the media. I also welcome Professor Peter Dawkins of the Melbourne Institute of Applied Economic and Social Research; it is great to have you here, too.

Today's public hearing is the twelfth since the Treasurer and the current Governor of the Reserve Bank of Australia agreed in August 1996 that the governor would appear before this committee twice each year to report on the conduct of monetary policy. These hearings have played a valuable role in enhancing community understanding of the Reserve Bank's role and policies. Today's hearing is also the second for our review of the bank's current annual report following the hearing held at Warrnambool last December. The committee will table a report when parliament resumes after the winter recess.

At this morning's hearing we will discuss a range of issues with the governor. These include monetary policy—in particular, interest rates, the recent rise in the value of the Australian dollar, the level of housing related credit, the impact of the world economy on Australia, the continuing economic impact of the drought and reform of credit card fees. To the extent we can, we will discuss this issue without canvassing matters currently before the courts.

This hearing comes at a time when the Reserve Bank has chosen, for 12 months now, to maintain the current official interest rate at 4.75 per cent, the longest period of stable rates since 1997-98. It also comes at a time when Australia continues to outperform the rest of the developed world, with growth of nearly three per cent expected for this financial year. This is on top of over 10 years of is steady economic growth—an impressive record by any measure.

Once again, on behalf of the committee, I welcome the governor and other senior officials of the Reserve Bank of Australia to this hearing. I remind you that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament.

Mr Macfarlane, I know you would like to make an opening statement before we proceed to questions. I think copies of that statement will be available shortly after you have made it.

Mr Macfarlane—That is correct. I will follow normal practice and start with an opening statement. In the six months since we last appeared before this committee we received a lot of information on the world economy, but it has not resolved the uncertainties we have lived with for a year or so now. As you will recall, 2002 started out on a promising note but the momentum of global growth waned in the second half of the year. A return to firmer growth was expected early in 2003, but observers watching for signs of that quickly found the picture clouded by concerns about the growing likelihood of war in Iraq and then its actual occurrence. The relatively quick resolution of hostilities and the associated drop in the oil price was a major plus for the global economy compared with the possible alternative. Confidence recovered some ground, and attention returned to underlying economic trends, but the incoming data did not give any encouragement.

It is now clear that a pick-up in global growth has not occurred in the first half of 2003. The international forecasting community have now pushed the forecast pick-up back to the second half of the year, though there are few signs in support of this. It is not surprising that, in this environment, financial markets are giving rather mixed signals. Around the world, bond yields have fallen recently to historical lows, indicating that participants in this market see a weaker global outlook for growth and inflation.

Equity markets, on the other hand, have been steadier after 2½ years of falls. In the United States, markets have even made noticeable gains in recent weeks, suggesting that some of the gloom may be lifting. Foreign exchange markets continue the trend that started about 18 months ago, with the US dollar falling, the yen remaining broadly stable and a group of currencies, including the euro, the Swiss franc, and the Canadian, Australian and New Zealand dollars all rising.

Where does that leave Australia? I will start to answer that question in the traditional way, by evaluating and then updating the forecast that I gave to this committee six months ago. When we met in December last year, I said that we expected GDP growth of three per cent through the year to the June quarter of 2003—in other words, through the current financial year. This was slower than in other recent years and an important reason for this was the temporary contractionary effect of the drought. When we moved the forecast horizon along six months—that is, to see the growth that occurred through the current calendar year—we expected growth to rise to 3¾ per cent.

In evaluating those forecasts, we see that the first one I gave you looks as though the growth through the financial year will be close to the three per cent forecast, or perhaps a little bit below it. We only have one more quarter of data to receive and then we will know the answer to that. As we look slightly further ahead, however, prospects are not as strong as they were. Instead of 3¾ per cent through calendar 2003, we now think the figure will be more like three per cent.

What has caused this downward revision to the outlook? The main explanation, you will not be surprised to hear, is the weaker performance of the world economy that we have seen to date, which is affecting Australia's trade performance. Our imports have continued to grow in line with our quite strong domestic demand, but our exports have fallen appreciably and there is less confidence that they will be lifted in the near future by firmer foreign demand. I will say more about that in a few minutes.

The inflation forecast I gave last time was for the rise in the CPI to exceed three per cent in the near term and then to ease to about 2¾ per cent in the 12 months through to the end of this calendar year. The first part of this forecast has occurred as the CPI in the most recent 12-month period—that is to the March quarter—ran at 3.4 per cent, pushed up by the high oil prices in that quarter. But the oil price pressures have already reversed and, when we looked at the likely outcome in the remainder of 2003 and into 2004, in our May statement on monetary policy—which came out a month ago and which I am sure all members of the committee have—we reduced our inflation forecast from 2¾ per cent to 2½ per cent, largely because of the higher exchange rate for the Australian dollar. Of course, since the statement was released, the exchange rate has risen further.

Let me say a little more about the domestic economy. The thing that stands out is that domestic demand has been growing at a high rate. For example, it grew by 6½ per cent last year. This was unlikely to be continued over a long period, and over the most recent four quarters it has slowed to 5½ per cent, still a good figure. We expect some further deceleration as we look ahead, but the most recent data do not suggest that the deceleration will be large.

Consumption has grown by 3½ per cent over the year to the March quarter and the more recent data, such as retail trade, show good rises in the most recent two months, March and April. Given the growth in employment and incomes and the fact that consumer confidence is above its longer-term average, prospects for consumption look quite good. Similarly, private investment, according to the latest Capex survey, is holding up well. We cannot expect a repeat of the 20 per cent growth we had last year, but a figure in the order of 10 per cent or a little lower is likely, given the strength of investment in buildings and structures.

The corporate sector as a whole is in excellent financial health, with conservative gearing, good profitability, and ready access to credit, although it is not using much of this because of its ample internal funds. Most of the surveys show readings at or above average for business conditions and business confidence.

I do not wish to say much about residential construction other than that it has held up for longer than we or other forecasters expected, but it now appears to have peaked, despite the boost it is continuing to receive from alterations and additions.

Within that general framework, the experience amongst different industries is, as usual, quite varied. Although in the aggregate growth has been good, some sectors are suffering. Agriculture during the drought is the obvious example and, of course, large sections of agriculture are still suffering. More recently, the tourist and international transportation sectors have suffered a sharp fall in activity, associated with the public reaction to the SARS virus, just when it looked like they were about to recover from the drop in travel associated with the Iraq war. Employment has grown by 2½ per cent over the past year, although, as usual, the pattern has been very irregular and the unemployment rate, at 6.1 per cent, is about as low as it has been in the present expansion.

As explained earlier, consumer prices are rising at 3.4 per cent per annum and wage costs at about 3.6 per cent. Inflation has been close to, or above, three per cent for more than a year. This would be a source of concern if we expected the situation to persist long enough to become entrenched in expectations but, as I said earlier, inflation is likely to decline in coming quarters and overall growth in labour costs is consistent with our inflation target. So the inflationary situation is not a cause for concern.

These figures that I have just quoted contrast with the much lower rates of increase occurring in major economies overseas, where demand is much weaker and where inflation targets—implicit or explicit—are, or are in danger of, being undershot.

Before leaving the domestic economy I will make a few remarks about the growth of credit. Aggregate credit has grown by 13 per cent over the past year, which is quite a high figure in an economy where nominal GDP has grown by six per cent. When we look more closely, we find that household credit has grown by 20 per cent and that credit to the household sector for housing purposes has grown by 21 per cent. Credit for investors in housing is estimated to be growing at about 28 per cent. Thus, we have a situation where credit is growing a good deal faster than appears necessary to satisfy the needs of the economy. This situation is wholly due to credit being channelled into the housing sector. When we see figures of this order of magnitude it is hard not to conclude that a significant part of this must be directed to speculative purposes. There is, of course, plenty of other evidence in support of this proposition.

So overall, an examination of the domestic economy leads us to conclude that there is little or no evidence to suggest that monetary policy has been too tight or is currently exerting a restrictive influence on domestic demand. But that is only part of the story, and possibly the smaller part. Policy must also take into account the impact of international forces. Let me now return, therefore, to the global economy, and then I will conclude by trying to make an assessment of the balance of risks which face the Australian economy.

After the short-lived optimism that followed the end of the Iraq war and the fall in oil prices, and amidst the flow of mixed economic data, observers of the international economy were confronted with two pieces of news, both emanating from the United States, which gave pause for thought. The first was the Fed’s communique from the early May Federal Open Market Committee meeting. That is their board meeting—the equivalent of our board meeting. In it, the Fed stated that the balance of risks on inflation for the US was in the downward direction. While the Fed did not mention the word ‘deflation’ and it clearly does not regard that as the most likely outcome, markets interpreted the Fed as saying that deflation was now at least a possibility that had to be included into the range of conceivable outcomes. US bond yields soon dropped to 45-year lows.

The second piece of news from the United States was the comments of the Secretary of the Treasury, John Snow, on the value of the US dollar. This was virtually unanimously interpreted as signalling the end of the so-called ‘strong dollar policy’ and an acceptance that a declining dollar was in the interest of the US economy. The interpretation gained added plausibility, despite later denials, when it was seen in conjunction with the Fed’s earlier announcement on the downward risks to the inflation outlook. The likelihood that the US dollar might decline further, with tacit acquiescence from the US authorities, has lead many observers to believe that a significant change is occurring in the international environment. A declining US dollar helps the US economy adjust to its problem but it also shifts those problems, in part, to other countries.

In passing, I have to say that I am not criticising the United States for this. To date they have shouldered more than their fair share of the responsibility for getting the global expansion going. But if we are interested in increasing global growth, rather than just having a redistribution of the pattern of growth between countries, many countries which so far have enjoyed the stimulus of exporting to the United States when the US dollar was high will need to find domestic sources of expansion. There is a great deal of scepticism about how successful the two main areas outside the United States—Japan and the euro area—will be in this endeavour.

It is in this general context that some central banks have reduced interest rates over the past few days. In fact, last night we saw the European Central Bank and the Riksbank, which is a Swedish central bank, reduce interest rates. As you know, earlier this week we had a board meeting and we did not. This was not because we are unaware of the downward risks that are presented by the global economy, nor because we think our economy is somehow immune to international problems. It was because we clearly have stronger domestic conditions in place already as a result of current policy settings, not to mention higher inflation than most countries. Hence we have not had the same sense of urgency in reducing interest rates that several others clearly did.

We are, however, very conscious of the risks the Australian economy faces. Obviously, the first one and the major one is that the world economy fails to recover and that in time this feeds through to a protracted weakening in the Australian economy. The main direct channel through which this could occur would be through a further weakening of exports. At the same time, we have seen that because our economy is healthy relative to others and hence our interest rates are not as low as others, foreign investors have found Australian dollar denominated assets attractive to acquire. Thus, a second channel could be through an excessive appreciation of the Australian dollar. Not that I think what has happened to date could in any way be labelled excessive. The trade weighted exchange rate has returned roughly to its post-float average, while the rate against the US dollar is still well below the post-float average.

On the purely domestic front, the main risk is associated with the rapid growth of household credit. Not only does it seem excessive in terms of purely domestic needs, it is far higher than in any other comparable country. Most of the credit has been directed towards bidding up the price of housing, and in some parts of the housing market the motivation has been dominated by the pursuit of speculative profit.

Will this domestic activity continue? I think there is now some evidence that in the most speculative hot spots a degree of commonsense is returning. Investor interest in inner city apartments, particularly in this city, is well down and quite a number of proposed projects have been shelved. In addition, estimates of future vacancy rates are being revised upwards and rents are falling. If this interpretation is correct, it should in time be reflected in the normal statistical collections on credit and prices. But these statistics inevitably contain quite long lags, so they will be the last indicators to turn down.

When we put these two sets of risks—the international and domestic—together, there are several possible outcomes. There are about four, in fact. Let me go through them. A weakening world outlook and an abating of domestic credit and asset market pressures would provide a reasonably clear prognosis for monetary policy. In other words, if it were weak internationally, and weak domestically, that would be easy. In the other direction, so too would a combination of a clear strengthening of the world economy and continued domestic buoyancy. That would be easy. A third possible combination, and the most favourable one for Australia, would be a firming world economy and an easing in domestic pressures, resulting in more balanced growth for the Australian economy.

But the combination that would be most damaging to the Australian economy would be if the household sector were to continue putting itself into a more exposed position at the rate it has over the past few years while, at the same time, a further weakening of the world economy was starting to feed through to Australian activity and incomes. That would be a recipe for ensuring that when the house price correction came, as it inevitably would if the world economy was weak enough, it would be bigger and more disruptive than otherwise. I am not saying that this is the most likely outcome, only that it is a risk that we have to take into account. It is this risk that adds an extra degree of complexity to the making of monetary policy in Australia, and gives some context to my earlier remarks about there having been less urgency in Australia than elsewhere to respond to the weakening world economy by reducing interest rates.

In conclusion, the international environment has not yet improved in the way we had hoped and the changing fortunes of the US dollar throw an additional complication into the mix. To date, the domestic economy has weathered the unfavourable international environment very well. Nonetheless, growth will be further adversely affected in the period ahead if the international situation does not improve. If this were to occur, it would change the balance of forces that has been keeping interest rates steady over the past year.

CHAIR—Thank you very much, Mr Macfarlane. As always, that was a very comprehensive assessment of the current situation. We certainly appreciate the amount of effort you put into that. The committee has received the opening statement as evidence on the record.

I would like to start with a question on interest rates and the effect of what has been happening overseas. As you mentioned, the European Central Bank have dropped their interest rate by half a per cent. It is already very low. The New Zealanders, as you have also said, dropped theirs by a quarter of a per cent yesterday, which comes on top of a quarter of a per cent drop last month. The other point is that, when the New Zealand governor announced that yesterday in his statement, he said:

> This slowdown mainly reflects the rapid appreciation of the exchange rate over the past 18 months, leaving the export sector more exposed to the soft world economy.

In light of that, would it be reasonable to say that, as compared to six months ago when I think you were suggesting that the pressure could be for interest rates to possibly go up, that is now not the case and, if anything, the likelihood is that if there is a move in interest rates it is more likely to be down?

Mr Macfarlane—Let me say first of all that I don’t think even six months ago I was saying that it was likely that interest rates would go up. I said that 12 months ago—I certainly said that 12 months ago. Six months ago my interpretation of what I intended to say was that anything could happen. There was no presumption that interest rates would go up; they could go up or they could go down.

I think it is quite clear that, as events have evolved over the last six months—not just here but everywhere else—the situation has changed again. What we really are talking about is whether interest rates stay the same or whether they go down. We are talking about what is the optimal path and we are talking about how some countries are influenced more by these considerations and other countries, essentially because they are healthier, are influenced less. But the framework that we are dealing with is one where the issue is: do we stay where we are or will we need to go down and, if the latter, would it have to happen quickly or could it happen in a more measured way? All the central banks around the world are grappling with that issue, and we are no different to the others in that sense.

You mentioned two particular ones there who, in grappling with it, came to a different decision this week than we came to. The first was New Zealand. You quoted from the statement that the New Zealand governor made, which I have also read. It is interesting and it is, to me, quite consistent with the difference between their position and our position in several points. First of all, their level of interest rates was higher than ours. They were a full percentage point higher. They are moving their rates down towards ours. So instead of being a full percentage point higher, now they are half a percentage point higher.

In their statement they made reference to their sensitivity to what has been happening to their exchange rate. I am not surprised, because the New Zealand dollar has actually gone up by more than the Australian dollar—not over the last week or so, but over the last 18-month period I described. When all these currencies—the euro, the Australian dollar, the New Zealand dollar and the Canadian dollar—were going up, the New Zealand dollar has gone up more than ours. New Zealand is a more open economy; because it is a smaller economy, it has a bigger trade sector than we do. So I think they feel it more acutely than we do. So I interpret the New Zealand situation as being one where their rates were clearly higher than ours and therefore very high by international standards. They are moving them down towards ours. The second factor, as I said, was that their exchange rate has gone up more than ours and they are more sensitive to their exchange rate.

In the case of the ECB, everyone knew that the ECB was going to ease. With the ECB, I think the urgency was much greater there, in fact, than it was for New Zealand. The main urgency for the ECB was not necessarily that the euro was rising. That was obviously a consideration. The history of the euro is that, when it was introduced, for the first two years it just went down, and then for the last 18 months or so it has gone up and it is basically back to where it started—about $1.18. So the rising euro is part of the story, but the bigger part of the story in the European area is that they have got almost no growth at all. In the first quarter of the year it was zero, and in the last quarter of the previous year it was negligible. To all intents and purposes the euro area is completely flat, showing no growth. In the euro area's biggest economy, which is Germany, there is serious concern about the fact that it is declining, virtually in recession again. If the word 'deflation' gets mentioned in the US, it gets mentioned a lot more in Germany, because the rate of inflation in Germany is about 0.8 of a per cent or something.

I think this theme will come up throughout our discussions today: there are healthy parts of the world economy and there are unhealthy parts. The timing of how these interest rate changes play out depends very much on whether you are in the healthy or the unhealthy part. But even if you are in the healthy part you are still part of the same world evolution.

CHAIR—You would still call us healthy?

Mr Macfarlane—Yes—in absolute terms and definitely so in relative terms.

CHAIR—I guess that raises the next question. You went through the scenarios in concluding your introductory words. You talked about the housing statistics inevitably containing quite long lags, so they will be the last indicators to turn down, but you do feel nonetheless that there are some signs of turning, and there certainly has been, as you pointed out, I think, in the unit prices in Melbourne and expectations there. I guess that raises the question: are interest rates really going to be dominant in that level of borrowing for housing, or is the level of interest rates more affecting the export performance vis-a-vis the dollar? Therefore, is that not a more significant weighting in your thinking now?

Mr Macfarlane—I think what I would like to say on this is that it is obvious, from everything we have said over the last year, that we have been disturbed by the speculative excesses that have been occurring in the housing sector. There is no doubt about that; we have said that again and again. And we think that it is in Australia’s interest for that to stop, to work its way out, as it inevitably will.

I made reference to the fact that credit, and possibly even the house price indices, will be the last things to turn down. I put that in there specifically because we cannot wait. Because of the external circumstances, because of the way the world economy is impinging on the Australian economy, we cannot wait until we have absolute irrefutable proof that the speculative element has gone out of the housing market. That would involve waiting far too long. So we cannot wait until we see the series for housing credit return to a normal level. We will probably have to make our decision on the basis of all the other partial pieces of information which we follow: the vacancy rates, the rentals, the stories that come out of the real estate researchers who tell you which buildings are being shelved and whether investors are still interested and whether they are not, particular anecdotal pieces of evidence about particular properties. We will have to make our decision once we think that there is some evidence there, because that will be the leading information. The lagging information—the last thing to show it—will be credit. That is why I made a reference to that. It would be a big mistake—it would be a policy mistake—to say, ‘We cannot do anything until we have irrefutable proof that all the excess steam has gone out of the housing market.’ We cannot wait that long.

Ms BURKE—Are you taking credit for what has already happened?

Mr Macfarlane—Some people have given me credit—the Housing Industry Association has. So that was the main part of that reference to the lagging indicator. The other thing I should say whilst we are on this subject is that there is a view that has gained currency that the only way the housing market will slow down would be if interest rates went up. I do not believe that. I think it is said by people who know that interest rates are not going to go up and, therefore, want to encourage further investment in the housing market. If you look at the history closely, you will discover that housing booms in the past have come to an end at a time when interest rates have gone up, but usually a recession has occurred at the same time. Which of those two things caused the housing boom to end? Was it the recession or was it the high interest rates that preceded it? You cannot really judge by looking at what happened in 1990, or looking at what happened in 1982 or looking at what happened in 1974, because both events occurred.

But there is an example where we had only one of the two events occur, and that was in the mid-1980s, when interest rates went to extremely high levels. In 1985 interest rates went up to 18 per cent—the 90-day bill rate went to 18 per cent—but there was no recession and there was very little effect on the housing industry. I read from that that interest rates are not the crucial factor. The crucial factor in determining the ending of a housing boom is when economic activity weakens, particularly in those earlier cases I referred to where there was actually a recession. People lose their jobs and they cannot pay their mortgages. That kills the housing boom stone dead. History shows that that has tended to be the main thing that kills the housing boom, not high interest rates—although normally the two things went together, so it was hard to determine it.

CHAIR—On what you have just said, the next question clearly relates back to the other side of your balancing. You point out the rising value of the Australian dollar, our relative interest rates and the attractiveness of, I think you called it, investment money. How much higher could the Australian dollar go before you would feel concerned that it is going to cause serious effects for our economy?

Mr Macfarlane—We have a floating exchange rate. That means we do not really have a clearly defined upper and lower band in advance—we don't know. I want to reassure you that it is not as though we do nothing, not worry about it until an alarm bell rings when it hits a critical level and then start thinking about it. The exchange rate is continuously feeding into the monetary policy decision. Every time you make a forecast of what you think economic activity or inflation is going to do, one of the important variables is the exchange rate. If the exchange rate has gone up between point of time A and point of time B then, other things being equal, your forecast for inflation will go down and your forecast for economic activity will go down, and that will influence your decision on monetary policy. It is continuously having an influence on our decision on monetary policy; it is not as though we have to wait for a particular level to be breached for us to start taking an interest in it.

Ms BURKE—There is a rapid rise in the Australian dollar and some are suggesting that monetary policy is too tight at the moment. We have noticed the financial markets coming out with profit downgrades for many of our blue-chip companies. This gives an impression that the markets are being surprised at the moment. You have given us ample indication over the numerous hearings I have been to that you do not like to surprise the market. Would you agree with some of your critics at the moment that the RBA has been asleep at the wheel?

Mr Macfarlane—You will be surprised to hear: no. The RBA has been constantly at the wheel, nudging it this way and that, and has been constantly reassessing how events are unfolding. However, we are not a body that acts at the first whiff of a problem. We weigh all the factors up together and evaluate what we think is the most sensible path for monetary policy in the medium term. We are fully aware of all those factors—as I said, they are constantly being fed into our assessment.

Ms BURKE—Given what is on the front page of the *Australian* today and other comments, is there conflict between you and the Treasurer and the Treasury about the direction of interest rates at the moment?

Mr Macfarlane—There is absolutely no conflict whatsoever between the Reserve Bank and the government. The views that I have just expressed here I expressed to the Treasurer as recently as last week, in the context of talking to him about a whole lot of other things. He is perfectly comfortable with those. I think what you have seen this morning is an overenergetic official somewhere in the bureaucracy who has tried to blunder into the debate; I am not suggesting for a minute that Dr Henry would be that official. This is not an example of conflict between the Reserve Bank and the government, and I think the government would be very irritated, just as I am rather irritated, when I see people blunder in in that way.

Ms BURKE—Given that you have said on numerous occasions that you will not release the minutes of the RBA board meetings to contradict these stories on the front page of the *Australian*, would you again consider looking at some report coming out after meetings—again, because rates did not move there is one line—so that we are not left to speculate about the actual discussions that went on behind closed doors about the RBA and whether there were contradictions between board members at the meeting?

Mr Macfarlane—I am not denying there was a difference of opinion between the Reserve Bank and the Treasury—that is actually quite a common event. The only thing that is different this time is that someone thought it was important enough to call a journalist and talk about it. But this is quite a common event; it happened quite a lot during 2000 and 2001. It has happened under all secretaries of the Treasury and governors of the Reserve Bank. It is not at all unusual.

Ms GAMBARO—I want to go back to deflation. You mentioned the risk, particularly with Germany. The IMF hosted a conference on 29 May. They said that we should be worried about deflation and they listed some countries, such as Japan, Hong Kong and Taiwan. What is your assessment of that, and are there any other high risk countries where you see that?

Mr Macfarlane—That little IMF task force shows how the word ‘deflation’ is now becoming a popular topic for discussion and is appearing in a lot of the economic debate. The first thing I noticed about that study was that they classified the world into four groups and, you will be pleased to see that Australia was in the group that was least likely to suffer from that problem. As for the allocation of the other countries into the four groups, I am not absolutely full bottle on that. Mr Stevens may want to say a few words on that, having given a speech on the subject of deflation in December last year.

Mr Stevens—It is true that there are several countries in Asia which are now experiencing, or have recently experienced, falling prices. Taiwan, if they are not there, are close. Hong Kong, of course, has had quite a pronounced deflation. China has had some, though in China at present they are back to a very slight positive inflation rate. Japan, of course, has had declining prices for several years and they, I think, are the clearest case of the bad form of deflation, which is due to chronically weak demand and which arguably feeds back into making demand weak again, so that you get a kind of vicious cycle. Apart from them, one has to say that inflation rates generally in most industrial countries are quite low and they are tending to fall, so it is not at all inconceivable that one or two more countries might find prices declining at some point briefly during the current downswing, and that is what I said in December. If the question is: is this likely to be a problem which we confront? I think that is quite unlikely. For a start, we are starting with a higher inflation rate than most countries. A lot of things would have to go wrong around the world for us to find ourselves in deflation, so I regard that as a very low likelihood outcome. I am not sure whether that is enough of an answer to your question.

Ms GAMBARO—Machinery and plant were one of those sectors where, over the last eight years, prices have fallen an average of 2.2 per cent. Does that concern you at this stage?

Mr Stevens—There are always parts of the economy where prices are falling in any economy. If we look at the average quarterly CPI figure, you will find that 30 per cent of the prices in the basket go down in an average quarter. So relative prices are always shifting and that means that there are always some prices that are falling. They are more likely to be prices in internationally traded manufactures where competition is extremely intense and in IT where technology gain and competition again forces prices down continually. Obviously, if you are a producer of those things, that makes life harder but I think that for the economy as a whole it is most sensible to regard it as a shift in relative prices rather than a portent of serious deflation, which is where all prices fall.

Mr COX—Mr McFarlane, you have confirmed that there was a difference of view between the Reserve Bank and the Treasury at the last board meeting. Can you elaborate as to whether the differences related to the forecast, to the assessment of risks or actually to what should be the principal focus of policy?

Mr Macfarlane—I would have a lot trouble doing that I am afraid, because the interchange was really only a matter of half-a-dozen sentences. I did not hear a fully articulated view of the world, so I think I would have a lot of trouble doing that. But it is not really in the way of forecasts I think, because our forecasts are very much the same. If anything, it is this evaluation of risks about the world economy. Any two reasonable people have a right to have a different view of the risks about the world economy. We concede without any trouble that there are very big risks there. In fact, last time at this meeting—I have got the quote here somewhere; it might take me a while to dig it up—I was asked the same question and I said, ‘Yes, we concede the risks are on the downside. If something very different to what we are assuming occurs it is almost certainly going to be on the downside.’ It is really not about who thought the risks were on the upside or who thought the risks were on the downside; it was a matter of who thought there were risks on the downside and who thought there were even bigger risks on the downside. So that was really, in essence, the difference. I am sure this is occurring in every country in the world: people are trying to make an evaluation of how big these risks are.

Mr COX—Are there also differences in the views of where the big risks are?

Mr Macfarlane—I do not know. I cannot speak for the Treasury on that, other than to say that they put a higher risk of a big surprise on the down side. We also have a risk for that but it is not as big.

Mr COX—Which is the greater risk in your view: the risk of a large adjustment in house prices in the housing market or the risk for the domestic economy of a further appreciation in the exchange rate with a negative impact on our export performance?

Mr Macfarlane—Again, it depends on the orders of magnitude. These whole things depends on the orders of magnitude. Clearly, if the appreciation were big enough and it were hurting enough, that would be a much bigger factor than if the housing thing went up just a little bit more. It is all a function of the orders of magnitude. That is why the assessment changes every month as you get more information coming in.

Mr COX—If there were a difference of view and a suggestion from Treasury that perhaps rates should be cut by a quarter of a per cent, then—looking at that as a policy move—do you think that would be sending an entirely wrong signal to the property market at the moment?

Mr Macfarlane—It could, yes. On the other hand, I do not think—as I said—at the end of the day that interest rates are necessarily crucial there. But there is a risk that that could give another final boost to a credit cycle that was very late in its maturity and was probably almost about to turn down. That would not be very helpful.

Dr SOUTHCOTT—My questions are along the same sorts of lines. At the conclusion of your statement, you looked at the four possible outcomes, which are variations of international outlook and also the domestic credit and asset market pressures. In the statement on monetary policy I think you have said that you expect some firming of the international economy. You also mentioned at the end of your statement some very early evidence that there may be an easing of pressures in the asset market or residential market. You have also said that the most damaging combination would not be the most likely outcome. Which outcome does the bank see as the most likely outcome of those four possible outcomes with the combinations of both?

Mr Macfarlane—At the moment, domestically we do have excessive credit. There is no doubt that credit is growing at an excessive rate. We definitely have that part. The question is whether it is coming down or whether the speculative part of it is abating. Our guess is that it is abating. But it is very difficult to find strong evidence that it is abating.

On the world economy, the jury is still out. When we look at the US, the US has a lot of problems but it is not as though it is actually in recession. It is chugging along at about two per cent per annum. It is actually in that indeterminate zone where it could pick up, which is what the majority of the world's forecasters think it will do, or it could continue to disappoint. I do not think it is going to plunge back into a recession but it could continue to disappoint. If it continued to disappoint for a short period, that might not be a problem for us. But if it disappoints for a long period, even without going into recession, then that could be a problem for us.

The whole thing is actually played out in slow motion. Each month, you get an update on where the probabilities are. At some point, which has not occurred yet, the probabilities will be such that you can say, 'This risk has gone up,' and either, 'That risk has gone down,' or 'That risk hasn't changed but this risk has gone up,' and that is enough for you to make a decision. This is evolving all the time.

Our position has evolved all the time. As I said, a year ago we were talking about the need to get interest rates back up to normal. Six months ago we were saying there is no presumption that we should do that any more. Now we are saying it is quite clear that interest rates around the world are going down. If these international developments continue, then we will no doubt at some point along the way participate in it unless there is a change for the better, and we see that this recovery is indeed occurring. So the whole thing is evolving. There is no sense of urgency. If you disagree with me about a decision on a particular month, that is not the end of the world. You get to make the decision again the month after that and the month after that and the month after that.

Dr SOUTHCOTT—I think you would say that the international outlook is weak right now. Also, we have strong credit and asset market pressures. You said that the most damaging scenario for the economy would be the combination of those two. Is it giving conflicting signals for monetary policy or is it that you might also see a bust or a drop in the asset prices as well?

Mr Macfarlane—At the moment it is giving conflicting signals for monetary policy; that is quite clear. What I was referring to is not what is happening now. I was referring to what might happen over the next 18 months. I was saying that if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing—the credit driven house price spiral—also continues over that 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession. That is what I was setting up there. I was saying that would be disastrous. I do not think that is going to happen because I can see the speculative excesses starting to abate. At the moment, the jury is still out on the world economy. It is going ahead at an unsatisfactorily low rate, but it is still growth. It is not as though it is in recession. But if that were to happen—if it were to go into recession and the speculative excesses of the housing market were to continue—then there would be a huge amount of distress at the end.

Mr NAIRN—Mr Macfarlane, given your comments on house prices and speculation and the associated risks, is there an even greater relative risk for regional areas? In quite a number of regional areas there has been a very rapid growth in land values and property prices. A lot of it has to do with the shift in baby boomers—people cashing in on the rapid increases that have occurred in property prices in many of the cities and moving elsewhere. This is having a fair impact on house prices in regional areas. I am talking about the relative risk in those regional areas as a result of that.

Mr Macfarlane—I doubt it. I think there is not a lot of risk. There is no-where near as much risk in an owner-occupier buying a house to live in, because there is very little speculative element in that. The part that becomes risky is when someone signs up to pay for something that is going to be completed in 18 months time, and then at that point they hope to rent it out to someone else whom they do not know for a rent they do not know. That is where the really speculative element comes in. But if someone in the city whose house has gone up in value decides that they would prefer a different lifestyle and they sell their house in the city and move to the country, I do not find that in any way worrying. In fact, it is probably a very satisfactory development for Australia. I would have thought that, by and large, the people living in the rural regions that these people move to would be quite comfortable with that.

Mr NAIRN—I guess it is the flow-on effect which I am talking about. Because of the push-up in values in those areas, there is a delay in the associated economic activity combined with the effect of the drought and different incomes. It is more the effect on other people rather than those doing the shift that I was talking about.

Mr Macfarlane—I suspect there is divided opinion in most regions when the money from the city moves in and bids up the property prices. I am sure there are a lot of people who are overjoyed and there are other people who are not too happy about it. But I do not think there is a serious financial risk involved. That is my only comment.

Mr ALBANESE—I want to raise a couple of questions with regard to employment. Firstly, the budget forecast has indicated a slowing in employment growth in the out years. To what extent do international circumstances beyond our control make even those lower employment growth figures optimistic? To what extent are they vulnerable and are we at risk of a considerable slowing there? Secondly, regarding a microemployment issue, to what extent is the household debt issue that you have raised concerns about linked to changes in the pattern of employment—in particular, the growing casualisation of the work force feeding into the growth of household debt?

Mr Macfarlane—On the first question, from my cursory memory of it I thought that the figures for employment growth in the budget were consistent with the figures for economic growth, so that did not cause me any concern. Your general point, however, has to be true. If it turns out that the world economy is much weaker than we are currently assuming, then those forecast figures for GDP will be lower than are currently forecast and therefore employment growth will be lower and unemployment will be higher. We all accept that that is a possibility and a risk. I have no dispute with what you say or what was said in the budget.

On the issue of household debt and the pattern of employment, I have not looked at it closely but some people have made the point—and there is a chicken and an egg problem here—that one of the things that has contributed to driving up house prices is that in many cases a mortgage is based on two incomes rather than one income. People are perfectly free to do that, and some of them would probably feel they needed to do that. But that may mean that if one income disappears there might be difficulty in servicing the mortgage, even if the other income is still there. Some people would see that situation as slightly riskier than the situation if we turned the clock back 30 or 40 years, where borrowing was based on one income. It is one of several reasons why the size of mortgages has increased so much.

Ms BURKE—You are concerned about this issue, though, aren't you? You have put out a paper entitled 'Do Australians borrow too much?' and another paper called 'Household debt: what the data show'. Half of your report for May 2003 is based on the notion that households have too much debt, that households are geared too much. You have talked extensively in these documents about record levels of debt and record levels of gearing, so it has to be a concern, hasn't it?

Mr Macfarlane—Yes, but I was not asked whether it is a concern; I was asked about a particular aspect of that concerning the changing structure of employment. It is a concern; you are right. We have made a major effort to try and draw people's attention to that, although I always have to remind people that 40 per cent of people in Australia own their homes outright, so debt is not an issue for them, and 30 per cent are renters. Only 30 per cent actually have a mortgage, and probably more than half of those have had a mortgage for quite a while, so it is a modest sized mortgage because it is run down. There is only really a fringe of people at the vulnerable end, but there are more of them now than there used to be.

CHAIR—Mr Macfarlane, you have tried to put it into perspective but, as Ms Burke has pointed out, it does dominate a lot of the thinking of the bank. It raises the obvious question—given the constraints you have in trying to work out where your optimum monetary policy is, and interest rates—would you like to see another financial tool available within the Australian economy to try to separate out the management of the two conflicting pressures?

Mr Macfarlane—We have another financial tool. It is called open-mouth policy, and I have been using it, but it may not be as effective as other tools you could conceive of. I am not putting in a plug for another instrument, although if in the longer run things turned out badly it would not surprise me if people started looking at other arms of policy—for example, tax policy. We have a tax regime in Australia which, compared to a number of other countries, is very favourable to property speculation. I am not saying ‘Change it’, but I would not rule out the possibility that if things do turn out badly there may be a public desire to make some changes.

Ms BURKE—There also used to be an open-mouth policy where the governor of the RBA used to talk to the major banks about their lending practices. You have also stated that half this problem goes to an opening up of the lending market—that there are all these new products that you can buy into which make it easier for people to borrow almost 100 per cent of their mortgage nowadays. Have you exercised your open-mouth policy with the banks over their lending practices and the directions they are taking?

Mr Macfarlane—I have spoken to some chief executives. The old open-mouth policy you referred to was more than that; it was a direct limit on how much banks could lend. You used to be able to say to them, ‘You cannot lend more than 8 per cent this year,’ or, ‘You are not allowed to lend more than 10 per cent this year.’ That was a characteristic of the old regulated system. We used to set the interest rates and not let them charge more than X for a mortgage. It was a characteristic of that whole system. So it was not just open-mouth policy; it was a very clear and very binding set of regulations which we have moved away from over the last 20 years.

CHAIR—Mr Macfarlane, surely if you are looking to ensure banks are exercising due diligence and taking proper prudential responsibility in lending and you are raising these concerns, isn’t there a point where you could follow up on Ms Burke’s point and say, ‘Hang on, the lending is now becoming too free’?

Mr Macfarlane—The body that has responsibility for this is APRA—and APRA has been talking to them. APRA is responsible for the prudential soundness of the banks, so APRA has put them through the hoops and said, ‘Are you sure that you are not putting the soundness of the bank at risk?’ The banks have said—and APRA has accepted and I accept—that this is not putting banks at risk. If this turns out badly, I do not foresee one of the results being banks failing. I do not foresee that all.

Ms BURKE—No, households could collapse.

Mr Macfarlane—I see household distress—that is what I see. I am not sure which part of the Australian government is responsible for investor or consumer protection—these are the issues we are talking about here. Neither the Reserve Bank nor APRA is the body that is responsible for either investor or consumer protection. I know ASIC, which is responsible for investor protection, has attempted to limit one aspect of this, which is the widespread growth of investment seminars where people come along and get told how to get rich quickly by using the equity in their existing home to gear up and buy a couple more apartments. ASIC would love to stop that. The problem is they cannot demonstrate that these people are in fact financial advisers. If they were, they would have control over them. But the people who run the investment seminars say, ‘No, we’re not. We are humble real estate agents and we’re not subject to your laws—we’re subject to state laws.’

CHAIR—Let us raise that. The latest *Economist* has a series of articles on this. The last sentence in one of those articles is:

Next time an exuberant estate agent tells you that bricks and mortar are the safest thing you can invest in, hit him on the head with this copy of *The Economist*.

Are you trying to say that there is something missing in public regulation?

Mr Macfarlane—The thing that has kept this going for as long as it has, has been the investor. The property developers will build things as long as there is an investor to buy it off the plan. This is the way that most systems operate: the investor is the customer. As long as the customers are there, this will continue. I have tried, and others have tried, to influence the investor, and I think with some success. If you read the newspapers, they often say that such and such has slowed down because of Reserve Bank warnings. Certainly the Housing Industry Association—which, by the way, does not disapprove of what we are doing—has said that the recent reduction in investor demand has been due to the Reserve Bank warnings.

Mr NAIRN—You said that 40 per cent of people own their own home, 30 per cent rent, and 30 per cent have mortgages, and a fair proportion of those mortgages have been going for some time. First of all, can you put a figure on the vulnerable section that you are talking about? Secondly, what exactly is the risk? Presumably, the risk is that they may have a drop in income or lose employment totally. If that does not occur, what is the ability now of the vulnerable section to pay the higher debt compared to, say, 10 years ago?

Mr Macfarlane—I gave a speech on this subject. It gets quite complicated. Basically, our view is that it has always been such that, when someone first takes out a mortgage and they borrow the maximum mortgage they can afford—I cannot remember the exact figure we use as an example, but they pay, say, 25 per cent of their income to service the mortgage—they are always very vulnerable. Even 20, 30 or 40 years ago a lot of people in this room, who are old enough to be in that age cohort, would have done that. They were vulnerable. If you lost your job then, you could not keep servicing your mortgage and you would lose your home. There is always a proportion in that situation: the newcomers to the market.

What is happening now is not that they are any more vulnerable than they used to be, but more and more people are permanently staying in that vulnerable state. They go out and use the equity of their home to buy another property or something else, so they keep themselves at the vulnerable end. So, instead of only a small proportion of the population being at that vulnerable stage of life, there is now a much larger proportion of the population. I do not know what the numbers are—they are probably very small. Maybe it used to be one per cent; maybe now it is five or six per cent. There is no science in those numbers, but that is what we are talking about.

Mr COX—This is the second Treasury secretary whom you have been at odds with to some degree on the stance of monetary policy. It seems from my observation that Treasury, perhaps under Ted Evans, had decided that they wanted to run the economy a little bit harder, and with productivity improvements that was possible. What implications on the exchange rate do you see with monetary policy now and what may it do to our export competitiveness?

Mr Macfarlane—Those two questions seem to be unrelated. On the first one, just look at the record of the Australian economy over the last 12 years. We do not have to defer to any country in the world in terms of our economic growth—its sustainability and our growth rate and our productivity. So if you have got a better basic formula somewhere, tell me about it. But the one we have used has produced the goods. So I do not feel I have any need to apologise or explain at all. I think the numbers speak for themselves on that first one. On the second one, I think you are asking the question that has really been asked before under various guises that amounts to saying: the appreciating exchange rate is a big issue; what are you going to do about it? I think I have answered that one before, that is, to date I do not think you can classify an exchange rate which has returned to its post float average as a problem. If it were to continue to appreciate at the sort of rate that it did in the month of May, I agree it could quite quickly become a problem.

My response—this is related to my response to the Chairman—is that there is no magic level where it becomes a problem. It was not a problem; now it hits the magic barrier it is a problem. It is continuously affecting our assessment of the growth prospects of the economy and the rate of inflation going ahead as it moves from the exceptionally low level that it was two years ago back to its normal level. That has already had an impact. That has already, at the margin, meant that you would want to run lower interest rates than you would want to run had it not done that. So it has already had an impact. It is one of the factors which has changed our perception—as I said, from a year ago when we were thinking we needed to get interest rates up—and put us in the position where we are now, where the discussion is really about whether they stay where they are or whether they go down. It is continuously being fed into our assessment.

Dr SOUTHCOTT—Thank you very much, Mr Macfarlane. I would like to ask you about Australian investment abroad compared with foreign investment in Australia. It seems that over the last four years we have seen an increase in Australian portfolio assets and equity overseas and over the last two years we are seeing Australian FDI offshore as well. What is the bank's analysis of it? What reasons do you see behind it?

Mr Macfarlane—On this question, it is true that in Australia, as in just about every other developed country, we are seeing simultaneously big capital inflows and big capital outflows. It is just part of the way modern developed economies behave in an integrated world. I got some figures out on this. Over the last decade in Australia our liabilities to the rest of the world—because of money that has come in—have gone up by 47 per cent of GDP. At the same time, our assets—what the rest of the world owes us because of what we have invested abroad—have gone up by 40 per cent. So there are very big movements on both sides. Some people might be worried about that but, to reassure you, let us look at a few other countries. If we look at Germany, for example, the figures were 88 per cent and 71 per cent. If we look at the United Kingdom, the figures were 168 per cent and 164 per cent. This is just the nature of the way modern developed economies behave in an integrated financial world. We own a lot more of them than we formerly did. They own a lot more of us than they formerly did. I do not see that as in any way being an increase in risk.

Dr SOUTHCOTT—To what extent is overseas borrowing by Australian banks funding this Australian investment overseas?

Mr Macfarlane—This is part of the same story. A lot of what we are calling inflow into Australia is Australian banks borrowing offshore. Why do they borrow offshore? Why do not they just borrow from Australian depositors? They borrow offshore at the moment—they are doing so much—because it is in their interests. It is cheaper for them to borrow offshore in foreign currency, then to swap that foreign currency back into Australian dollars so they have themselves in a hedged position. They are not taking a foreign currency risk. When the sharp pencil men go through and work out the cost of funds, it is a few tenths of a percent cheaper than if they had borrowed in Australia. That is why they are doing it. The reason it is a few tenths of a percent cheaper at the moment is because there are a lot of people out there who are very comfortable taking an exposure to the Australian dollar. This is the way they do their business. If that were to change, then those few tenths of a percent would move the other way and they would start wanting to borrow domestically.

Dr SOUTHCOTT—I do not think that in your opening statement you said anything about the current account deficit. Do you have any comments on the current account deficit?

Mr Macfarlane—I do indeed. I am sorry. You are right, I did not say anything. I implicitly said something about it, because on a number of occasions I referred to the fact that our exports were falling and our imports were rising. As a result of that, our current account deficit has been widening. A figure for the first quarter came out a couple of days ago. It is 5.3 per cent of GDP, which is a fair bit higher than it had been two years ago—not surprisingly. Is this a cause for concern? At the first level, I would say it is not, because it has been over six per cent on four or five occasions. In fact, it was temporarily over six in the December quarter because of all those Qantas planes that were imported, and it will probably go over six again. I will be very surprised if it does not go over six at some stage later this year. That is a pattern that we have had in Australia for 20 years or more: when we are doing well and the rest of the world is doing badly, our current account deficit goes over six per cent. People could say, 'That's okay, but what if it goes a lot higher than that?' We cannot rule that out. If that were to happen, I think it would still be mainly a reflection of what we have been seeing, which is domestic demand in Australia being strong relative to the rest of the world. If that were to happen, would that lead to some disastrous result? I think it may well lead to a reaction, but I suspect the main reaction would be for people to become more wary about holding the Australian dollar and the Australian dollar would then start to go down.

Dr SOUTHCOTT—In the past, when the Australian dollar has been falling, we have not seen the rise in exports that you might expect due to competition in the Australian economy. Can we now expect the opposite with a strengthening of the Australian dollar—falls in the price of imports?

Mr Macfarlane—That is a technical point, and I think the answer is: we would not see as much downward pressure on prices as you would have been led to expect under the earlier relationship. Basically, you would see a rebuilding of profit margins.

Proceedings suspended from 11.23 a.m. to 11.42 a.m.

CHAIR—In this half we will try to expand into other areas, away from monetary policy. But I have a small technical question. Mr Macfarlane, I think it is now customary for any changes you make to interest rates to be announced the day after a board meeting. However, that has not always been the case. Is there still discretion there to delay announcing a decision?

Mr Macfarlane—The discretion is there, but we have not used that for quite a while. We did earlier. When I first took this job we used it on a number of occasions, so change has occurred while I have been in this position. The emphasis on transparency means that it would be difficult, unless the circumstances were exceptional, to have a meeting, agree to do something and then not do it for two weeks. I think the way the world works now is that, once you have made up your mind that you want to do something, you do it and you announce why you do it. That does not rule out what would happen if an exceptional circumstance occurred. For example, after September 11 a number of central banks—which, like us, would normally only act immediately after the board meeting—took action in the interval between board meetings because they felt that an exceptional event had occurred. You might remember that we did not. We did not think it was exceptional enough for us to want to act. We did subsequently take some action, but we did not do it in between meetings. So it is unlikely unless a big event occurs. I think the market reaction would be very large if you did something between meetings other than in response to an exceptional event.

CHAIR—I want to give you one more opportunity to make a comment on housing. The article in last week's *Economist* made the comment that the PE—price to earnings—ratios for Britain, Australia and the Netherlands pointed to a pronounced bubble, suggesting house prices in all three countries were at least 30 per cent too high. Would you comment on that.

Mr Macfarlane—I do not think that was a particularly sophisticated piece of research. They basically just looked at house prices to incomes and said they are 30 per cent above their average levels or above the trend. I do not think they have adequately taken into account in their calculations the fact that you can borrow more in a low interest rate environment than in a high interest rate environment. So their figure is biased upwards. In our view, it is an overestimate.

Ms BURKE—Going back to the discussion we were having before, you were talking about putting some brakes on people overextending in the housing market and you referred to the lack of regulation in the area. Do you believe that ASIC or some other body needs the power to say to lenders that it is inappropriate to conduct these seminars and then to offer people properties—to give them advice about how to get the money and then say, 'By the way, I've got this fantastic waterfront view for you'? Is there something missing in law and regulation that needs to be given to ASIC or someone of that ilk?

Mr Macfarlane—Yes, I think there is a regulatory gap there. It is clearly a problem if there is one group of people who are holding seminars on how to invest your money who are regulated—the financial planners—and there is another group who are doing almost exactly the same thing, although doing it within the one asset class, which is property, who are unregulated. So I think there is a need to extend the capacity for ASIC to do that.

Mr COX—You painted a reasonably bearish picture at the extreme end of the risk scale before the break. If that eventuality were to turn out to be correct, would the government be meeting its fiscal target of achieving balance over the course of the cycle?

Mr Macfarlane—Obviously, as a purely neutral statement of economics, if output growth and income growth were to decline, then one would expect the budgetary position to change. I would expect it to change and I would be very disappointed if it did not change.

Mr COX—But that is not answering the question about the government's fiscal policy at the moment, which is to achieve balance over the course of the economic cycle. Certainly the budget balance would turn around, and probably dramatically if the circumstances you are talking about happened. If there was going to be that kind of event, has fiscal policy being tight enough in the latter part of the cycle in recent years?

Mr Macfarlane—The answer to that is probably yes. We are in a remarkably strong position for our fiscal policy to withstand a contraction. The biggest indicator of that is that the stock of government debt on issue to GDP is probably the lowest in the world. Unlike a lot of countries who have already used up their fiscal ammunition, we have not used any of it yet. So I think we are in a strong position in that sense.

Mr COX—Were you relieved about the Treasurer's decision to abandon his project to get rid of the bond market?

Mr Macfarlane—I do not think he had a project to get rid of the bond market.

Ms BURKE—I think he did.

Mr Macfarlane—We were all in this awkward position where, if a number of independently worthwhile events occurred, a corollary would be that there would not be any government debt on issue, and that would have some implications for financial markets. In the event, it has not occurred. I managed to stay on the sidelines throughout; I think I will stay on the sidelines.

Ms BURKE—My question flows on from that and goes back to Andrew's question before about the current account deficit, which is tracking fairly similarly to how it did in 1997, around the time of the Asian crisis. We managed to congratulate ourselves that we came out of that unscathed. Monetary policy was a lot tighter then, though, and the Australian dollar was not appreciating as it is now. Do we need to cushion the Australian dollar to ensure that we can survive the same impacts we are having in terms of the current account deficit now?

Mr Macfarlane—I think you said that monetary policy was a lot tighter then.

Ms BURKE—Sorry, it is the other way around. What I am trying to say is that the Australian dollar was lower—my apologies. So do we need to tighten the dollar now to cushion ourselves against the growth in the current account deficit?

Mr Macfarlane—During the Asian crisis we did nothing. That was our great success: to do nothing. Everyone else tightened and we did not. We did not actually loosen, we just did not tighten, and we got through the Asian crisis very well. It is true the currency did weaken, but it did not weaken anywhere near as much as it subsequently weakened in 2000-01. So it turns out that our currency was more affected by the fashions of financial markets during the new economy age than it was by this very profound event: the Asian crisis. We actually entered this current phase of world weakness with an exceptionally low currency, as you know. The recession year was 2001, and in May 2001 we had an Australian dollar at 47c. So we entered this thing with an exceptionally low exchange rate, which is one of the reasons why it has gone up—the starting point was just so low.

Ms BURKE—So you are not concerned now that the differentials between us and the rest of the world are growing so greatly, particularly if you look at us versus the US?

Mr Macfarlane—We definitely take it into account.

Mr NAIRN—In Warrnambool six months ago we talked about the potential impact of the drought. At that point in time, the drought had been going on a little while but probably not long enough for us to understand what the impact might be. Six months on, we have seen that impact a lot more closely in some of the figures that have come through, particularly in the last few days. Has the impact been about what you might have expected, or a lot greater? How much do you think that will improve in the next, say, six to twelve months?

Mr Macfarlane—I am happy to answer the question, but I do not profess to be the greatest authority on this subject. The greater authorities are the Bureau of Meteorology and ABARE—the Bureau of Agricultural and Resource Economics. Our rough assessment—which is based on information we get from them—is that farm production will have fallen by about 30 per cent in this current financial year. This would take 0.9 of a percent off GDP. The rough rule of thumb we had is one percent. We were talking about how the drought would take one percent off GDP. It looks like it has taken virtually that—0.9 is very close to one.

When we look ahead, it gets a bit trickier—and this is where the Bureau of Meteorology is of more use than any economist. They have declared that the El Nino event is over. That has to be good news. Some parts of the country, as you know, have received the benefit of that, but other parts have not received much benefit at all. Southern and central New South Wales and parts of Victoria have got virtually no benefit, but other parts have—Queensland, northern New South Wales and Western Australia. ABARE, on the basis of that information, are forecasting that there will be a rebound in agricultural production because at least a significant part of Australia has recovered. They are expecting that it would add about three-quarters of a percent to GDP in the coming financial year. So we are not quite recovering the loss of the last financial year, but we are recovering most of it.

Mr NAIRN—I want to ask about things like farm management deposits and the drawdown. You commented that at the time farm debt was in a very good position, that there had been a good repay of debt over a period of time and that that had not had much impact. What has happened since then with respect to that and with respect to general farm debt? A lot of people were surprised at the end of last year that with the drought there was not a greater pull-down of FMDs and a build-up of overdraft. What is the Reserve Bank hearing about that?

Mr Macfarlane—I fear that you probably know more about this subject than I do. There is probably more information in your question than you will get from my answer. Can you add anything to that, Malcolm?

Dr Edey—Farm debt is going up but not at a particularly rapid pace. You are now starting to see some drawdown of the farm management deposits, but I think we are only seeing the early stages of that now. Where you would be likely to see it starting to come through more quickly is as people draw funds to invest and plant in the current season. I think we will be seeing more of that coming through around the middle and later part of the year.

CHAIR—I want to get onto the subject of bank fees and other associated fees. I note that you have an article on that in the April *Bulletin*. We have discussed competition with the banks in the past. Although it took some time, the business loan margins came down more quickly than they did for the personal and small business loans; the pressure has brought them down. At the same time, we have seen quite an increase in fees. I know you have said on many occasions and again here that the increase in fees has not offset the drop in margins, but it is still true that fees charged to households in 1997 were $1.2 billion. There has been an increase of 123 per cent, $2.7 billion in 2002, while for business there has been an increase of 78 per cent. In other words, fees for households have gone up quite dramatically. There are winners and losers. At the end of the day, is this an example of the banks recouping what they lose one way and not really being under proper competitive pressures to keep those fees down?

Mr Macfarlane—I will not attempt to answer that, because I have not read that thing recently, but Rick, who probably wrote it, would be in a better position to answer your question.

Mr Battellino—It is certainly the case that fees on households have, over the period we have been collecting the data, risen faster than fees on businesses. As far as we can tell, one of the important reasons for that is that the volume of transactions that households do with the banks has increased enormously over that period. The main sources of the fee rise are fees on credit card transactions and fees on housing loans. Both of those have been rising very quickly over this period. In that respect, it is not surprising that the overall fee income earnt by banks from households has risen. The actual fees charged per transaction, particularly in the case of housing loans, have fallen substantially over that period, partly because the banks are under competition from non-bank lenders, who have cut their fees. To the extent that there is a story there, it is the fact that the volume of transactions that households are undertaking with the banks is increasing so quickly.

CHAIR—But are there competitive pressures there? For example, you talked not only about housing borrowing but also about credit cards and so on. The banks have a very hefty interest charge on credit cards, and they also introduce all sorts of ways of trying to supplement their income. A recent example drawn to my attention is of a household running up, say, $1,000 on a bankcard and then choosing to pay back $800. The banks would still charge the interest on the full $1,000, even though the outstanding amount was only $200. That is a relatively recent innovation in raising income. My question is: is there sufficient competitive pressure and, if not, as you have done with interchange fees, what pressure can you put on them?

Mr Battellino—The competition really comes from competitors outside the banks. If you get a free market with new competitors coming in, that is where the competition comes from. We have seen that most particularly in the case of housing. We first saw it with interest rates back in the mid-90s, as all the non-bank mortgage providers came in. Then we saw it with the fees that banks charge. When you applied for a loan they used to charge $800 or $1,000; that has come down substantially. Again that has been because of competition from outsiders. On the credit card business, I think the outsiders have more trouble in competing there. This is the issue that Ian has been on about with the credit card reform. That is what it is all about.

Ms BURKE—Doesn’t it also get back to the products that the bank are pushing—revolving lines of credit, frequent flyer points? The reason there has been such a huge increase in people using credit cards is that they have been told by the banks to pay for everything on credit cards.

If you go to the Centrelink website, the No. 1 preferred method of paying off your family debt is by credit card. Fantastic—pay your debt by incurring another debt. Haven't we gone insane? I know it is not your area. Sadly, it is nobody's area because the ACCC cannot get a reference from the Treasurer to look into this area of fees and charges. So I suppose my broad question is: should the Treasury give the ACCC a reference so it can look into fees and charges and should someone be monitoring the excessive pushing of credit cards as a means of payment? It is becoming the most preferred method of paying everything.

Mr Macfarlane—I can go some way towards answering the question the chairman asked as to why we cannot do something about these various fees you are referring to, the way we did something about credit cards. The thing about the regulation of credit cards was that we did not seek to regulate any fee a bank charges its customer. We rely on the market to put some discipline there. You can argue one way or another whether there is enough discipline. The only fee we were involved in was a fee which was not set in the marketplace but which was set collectively by providers of the product. That is why we made the changes that we did to the interchange fee. That was not a market set fee. It was not a market price. It was determined collectively.

On your second issue of why so many payments are being made with credit cards, some of that is starting to change, partly because merchants now have more freedom to accept or reject a credit card. More particularly, they have the freedom to pass on the costs that they got hit with from the bank to the customer and therefore give the customer the option of using a more efficient and cheaper form of payment than the credit card. We are starting to see some signs of that coming through—not on a big scale, but we have seen signs of that happening. That was one of the purposes of the reform of credit cards—to give the merchants back some of the power that had been taken away from them.

Mr ALBANESE—On this issue it seems there has not been as much movement as we would like. The last time we were in Melbourne we were discussing these issues, including interchange fees. Why is it that banks charge an interchange fee of 64c on BPay—bill payments—if you pay from a savings account; whereas if it is done through EFTPOS there is no interchange fee, something that you have supported? Why the distinction there and what is the bank's view of that? Secondly, in terms of BPay interchange and the ACCC review of it, why didn't you undertake a review and what is your view of the ACCC decision to essentially take no action—hands off?

Mr Macfarlane—I am sorry that I am going to have to disappoint you on this in that I actually do not know enough about BPay to answer you. It is true I am the Chairman of the Payment System Board but I am very much the chairman; I am not the expert on the Payment System Board. Unfortunately, there is no-one in the group of people I brought with me today who can answer. We had to leave behind our payment system expert. I am only too happy to get back to you and take that question on notice. I am sorry; I cannot answer it.

CHAIR—I think it would be good if you could get back to us on that and maybe on the wider issue of what progress reform is making and what the expected further reforms are.

Mr Macfarlane—I can talk on credit cards, debit cards and ATMs—when I say debit cards, that is EFTPOS; it is the same thing. But I am not full bottle on BPay, sorry.

Mr ALBANESE—Taking up that issue as well, why hasn't there been one review, a general review, into all of these payments—debit cards, ATMs, credit cards and BPay? It seems that there are ad hoc little inquiries about essentially what is fundamentally, in my view, the same issue.

Mr Macfarlane—The reason is that we thought—and we still do—we could get the sorts of reforms that the community needs voluntarily on EFTPOS and on ATMs. But we clearly were not going to get that on credit cards. Credit cards are a much more difficult issue. You can see that by the fact that we are now involved in a very long court case with Visa and MasterCard, who play either no role or only the tiniest role in the EFTPOS or the ATM issue. The credit card issue is going to be a much bigger issue to crack than the other two.

CHAIR—We have been talking about this for some time now. You say that you hope that it will be a voluntary improvement in the lowering of costs and so on. Are you satisfied with the rate of improvement?

Mr Macfarlane—I was not satisfied for a while, but I think I am satisfied that on EFTPOS, the main players—although not 100 per cent of them—who are the banks, have put a proposal to the ACCC to just abolish the interchange fee; to just get rid of it completely. We think that is a very constructive step. That is probably what we would have sought to do had we gone through the formal channel of designating that payment stream and doing the sort of thing we have done with credit cards. That is an example of where, with a bit of luck, we will get the same result without having to go through the elaborate procedures we have been through with credit cards.

CHAIR—Do you feel that there is a difficulty in defining who has real responsibility here or do you feel that you have resolved that now?

Mr Macfarlane—I do not think there is. The quickest solution—the lighter touch solution—is actually to go through the ACCC. That is how, if you remember, the credit card reform started. But then it got bogged down when it became clear to us that the authorisation procedures of the ACCC were going to be very time consuming. The ACCC cannot say, 'You are doing it this way; you have to stop doing it that way; you now have to do it this way under authorisation.' All they can do is say, 'What you are doing at the moment is not in the public interest. Go away and come back with another proposal which we may then decide is in the public interest.' That procedure depended very much on the cooperation of the institutions involved and they were not giving it on credit cards, so both we and the ACCC decided it was much more effective to go down this so-called designation path. On EFTPOS, they are getting the cooperation. They have come back to the ACCC with what is a very constructive proposal. I think that one will go ahead on a much better path.

CHAIR—Has anyone else got any questions on that? If not, we will move on to a couple of other areas. With the US and its twin deficits nowadays—both the budget and the balance of payments—and a number of countries such as Japan, Taiwan, Hong Kong and so on having quite large reserves held in US dollars, is there any concern that those countries may choose to change where they are holding their reserves? If so, what are the impacts likely to be of that?

Mr Macfarlane—My understanding is that some of the Asian countries, with very high levels of international reserves, have in fact switched some of their reserves out of US dollars and into euro. The implication is that it is one of the factors that drives up the euro and drives down the US dollar. Is that correct, Rick?

Mr Battellino—Yes, I think so.

Ms BURKE—So why are we continuing to have all our reserves in US dollars?

Mr Macfarlane—We do not. In fact, we are one of the few countries that has as many reserves in euro as we have in US dollars. In fact, we made a decision about 18 months ago to increase the proportion of our reserves in euro.

Ms BURKE—For that reason?

Mr Macfarlane—No, not for that reason, because you do not try and play the market, as it were. It was a longer term—

Ms BURKE—Other people have, and they have not done it very well.

Mr Macfarlane—It turns out that it worked out okay, but that was not the motive; the motive was a much longer run view of how the world might evolve over 20 years. In fact, that was part of the decision to reduce our holdings of yen—that was the main motivation for our change. We took what used to be in yen and put it into euro, which built the euro share up to the US dollar share.

Mr COX—Have you got a benchmark for the proportion of your holdings?

Mr Macfarlane—Yes, we have 45 per cent euro, 45 per cent US dollar and 10 per cent yen. We publish that every year.

Ms BURKE—Do you review that?

Mr Macfarlane—That was the review that—

Ms BURKE—Yes, but I mean considering the movement in the US dollar at the moment?

Mr Macfarlane—Yes, we keep it under review, but it is not the sort of thing you would expect to change very often. If you were changing it regularly you would be playing the market, and we try not to do that. The old benchmark must have been in place for a good 10 years or so. It has been changed once in that time, and that was 18 months ago.

CHAIR—Another quick question: has any work been done on developing a common currency with New Zealand? Do you see any benefits in doing that?

Mr Macfarlane—We have not done any work on that. I think the Treasurer has pronounced on that on several occasions. His view, if I am correct, is that if New Zealand wants to do that then he would respond favourably to anything they had to say, but I think he made it clear that the currency concerned would be called the Australian dollar and nothing else.

Ms BURKE—I will move on to something near and dear to my heart that I talk about all the time: APRA. Regarding the RBA and its role on the APRA board, do you think you came out of the HIH royal commission review lightly?

Mr Macfarlane—The first thing is that there are, I think, 2,400 pages of the report, of which 100 were devoted to APRA. In the end, Commissioner Owen said:

> ... APRA did not cause or contribute to the collapse of HIH; nor could it have taken steps to prevent the failure of the company.

They are the words of his finding. That does not mean he did not make some criticisms of APRA—he did make some criticisms of APRA—but, if you read the report, I think you will find that he made a very balanced judgment. He did concede, for example, that APRA was in its infancy and that it was still trying to draw together resources from Canberra, Sydney and Brisbane—it was trying to draw together three separate organisations into one. APRA was under the disadvantage of having a staffing level which was going to be lower than the sum of the three previous institutions that it replaced. I thought he was quite understanding in the way he did that. He also drew out the fact that what got APRA into trouble was something that it had inherited from the ISC. It was smouldering away there, it was going to happen at some stage, and it happened on APRA's watch, which was very embarrassing for APRA, but it was something they inherited from the ISC. The principal staff who were monitoring it from APRA's point of view were also staff it inherited from the ISC. So I thought his finding was quite fair and balanced.

I might also point out that he did not make any criticisms of the APRA board—not one. What he said in relation to the APRA board was that he could not see the logic for it in the first place, and that is why he recommended the ending of the APRA board. I have to say that I also agree with him on that. I always found that it was an overly elaborate form of governance and that is the view that he took, partly of his own accord and partly because he had discussions with Mr Uhrig, who as you may know is going to report on governance of statutory authorities. I am quite comfortable with what Mr Justice Owen said about APRA and about the APRA board, and I am comfortable with what he recommended, which is that it no longer have a private sector type board, which is what it had, with a separate chairman and a separate CEO. I had let people know for some time that I thought it was a particularly cumbersome governance arrangement and I am not surprised that he had the same view.

Ms BURKE—Recommendations 18, 19 and 20 go to, as you say, getting rid of the board and setting up an advisory board. Recommendation 20 clearly states:

> I recommend that the direct involvement of representatives of the Australian Securities and Investments Commission and the Reserve Bank of Australia in the governance of the Australian Prudential Regulation Authority be discontinued.

What is your view on that recommendation?

Mr Macfarlane—If you read his arguing for that, I think it was quite right. Really it was saying that if you were the CEO of APRA, to do all the things to run APRA—the personnel decisions, the budgetary decisions and all the sorts of things involved in running an organisation—you had to report to a board, which included people who are running similar organisations, giving their opinion on how you should be organising your budget, how you should be paying your personnel and who you should be promoting. It was really very intrusive to have the head of ASIC and me virtually being expected to help the head of APRA make those sorts of decisions. That is one of the points that Mr Justice Owen made. I reiterate, I agree with his conclusions.

Ms BURKE—He also said that there was an assumption that at board level, discussions were actually happening between APRA, RBA and ASIC. He said that people further down the line were assuming that those discussions were happening at board level and he said that they obviously were not happening because the information was not being exchanged. Do you think that was a fair criticism?

Mr Macfarlane—I am not sure that he said it quite that way. I think what he said was that you have established clear channels of communication at staff level and you have memos of understanding between the three organisations so that information will be exchanged at that level. But at the same time, you are duplicating it by having another channel of communication at board level. If you have duplicate lines of communication, you run the risk that people assume that the information has been passed along one line of communication when it has not and, in the end, it does not get passed along either line. I do not think he felt that lack of communication between the three institutions was relevant to what happened in HIH. He just made the logical point that it is a mistake to have two separate and independent lines of communication.

Ms BURKE—He made some reference though that he believed—I am paraphrasing—that Wallis probably got it wrong and that bank regulation should never have actually gone over to APRA but should have stayed with the RBA. Given what has now transpired and the changing of the board arrangement, do you think bank regulation should be returned to the RBA?

Mr Macfarlane—No, I do not. As you know, we argued against a number of aspects of the Wallis report, but on that particular issue, which is a very large issue, we said that we accepted the umpire’s decision. It is clear that in a number of other countries, a similar change occurred and an independent prudential regulatory body was set up that looked after banks, insurance companies, building societies, credit unions, the pension industry et cetera. Either system can be made to work. We have no desire to turn the clock back to the old system, which did work. If you remember, Wallis did not say that it did not work; he just said that this would be better way of doing it. But we have no desire to turn the clock back. We want to do what we can to make sure this system does work. I think it is extremely unfortunate that in its most vulnerable period, in its infancy, APRA was hit with this once in a 20-year shock, which was going to hit at some stage. It is quite clear from the royal commission that it was an accident waiting to happen; the size of it had been building and building and eventually it blew up.

Mr COX—Have there been any other adverse consequences in terms of the rest of the Reserve Bank’s responsibilities in having lost prudential regulation of the banks?

Mr Macfarlane—I do not think so, no. We gained a new responsibility, which was the regulation of the payments system—which has turned out to be at least as intellectually demanding as regulating banks was. Maybe I am exaggerating. It has been, over the last 10 years, at least as intellectually demanding as bank regulation has been over the last 10 years. I am referring to the fact that bank regulation has gone extremely smoothly.

The other thing is that we do retain the chairmanship of the Council of Financial Regulators. I think the point that Mr Justice Owen was making was that this was a very good body but it had been slightly sidelined by the fact that the members of it were also, by and large, members of the APRA board. So the work that they would normally have been doing at the quarterly meeting of the Council of Financial Regulators they were doing in their monthly APRA board meetings. So the APRA board had become, de facto, also the Council of Financial Regulators. So, on the one hand, the board was asked to do a huge amount of work for APRA—the sort of work which normally an executive committee would do rather than a board—and, on the other hand, it was also de facto doing the coordination role between the various regulators. Under the new arrangements, that will not be the case. The Council of Financial Regulators will be the peak body to make sure that coordination occurs at the highest level between ASIC, APRA and the Reserve Bank. I think that is a good solution.

Mr COX—There are no insights into the operation of the financial system that you are missing by not regulating the banks?

Mr Macfarlane—At the margin, you may be right—but I would say it is only marginal. As soon as we lost bank regulation, we set up a financial stability system group, which was headed by John Laker, who is an assistant governor at the same level as the two gentlemen on my left. That group has joint responsibility for the payment system, which brings us into constant contact with banks—because, basically, they are the payment system. We are the centre of it, but they are the main body of it.

We also have a department which just deals with financial stability issues, just looking at all the financial risks that occur in the community as a result of the changes in products, the growth of derivative markets and the growth of these credit derivatives—all those sorts of things. This small team keep in touch with that constantly. They are also responsible for our relations with APRA and they are also responsible for supporting me in my membership of the Financial Stability Forum, which is an international body. I would have to say that whatever loss of expertise or feel for what is happening that has occurred because we no longer do face-to-face supervision has been very marginal, because I think we have made up for it with our other activities.

Mr COX—One of the things that I have noticed over the years is that any organisation that is basically appended off the Treasury portfolio, with the exception of the Reserve Bank, tends to be restricted somewhat in the amount of resources that it is given to perform new functions. Do you think that is a problem with APRA?

Mr Macfarlane—I think that was a problem in the formation of APRA, yes—I think that is quite clear. Mr Justice Owen makes it clear that it was a mistake for the Wallis committee to come out and say, ‘Not only have we got a better system of regulation; it is going to be cheaper and it’s going to involve fewer people.’ That was a mistake. The government accepted the Wallis committee advice on that, and they now recognise that it was a mistake, because they now have, as a result of this very unfortunate experience, increased the allocation to APRA.

Mr COX—I had serious concerns in the course of the previous government about the ISC and the resources that were available to it. When I tried to pursue those concerns, I found that Treasury could not nominate anyone who was competent to look at the ISC to see whether it was doing its job. Who would you see as being the most competent group in the official family to give the government advice as to whether APRA is functioning well?

Mr Macfarlane—I am not sure what you are asking for. If you are asking which body is most capable of doing prudential regulation of the various groups of financial institutions, APRA will be able to do that. As to who would advise the government about how to handle APRA or how to construct APRA, a whole lot of bodies have given their advice and obviously Treasury has a very big role in that. Commissioner Owen has given some advice, Mr Uhrig has given some advice and I have given some advice. Between the four of us, with a bit of luck, we will get it right.

Mr COX—The Auditor-General has been doing a series of performance audits on APRA'S various functions. Since I have been off the public accounts committee I have lost track of how those are going. In a policy advising role, who do you think provides the Treasurer with advice on APRA's performance?

Mr Macfarlane—I presume that is Treasury. It is their job to provide advice to the Treasurer. Clearly, the overwhelming event that has drawn attention to APRA is the failure of HIH. I do not think anyone had to interpret that, because we had a royal commission and the royal commission is the biggest single source of advice. I do not know that there is much more I can say about that other than APRA was most unfortunate that, in its infancy, when it was still putting itself together, it got hit with a once-in-20-year tidal wave.

CHAIR—Mr Macfarlane, moving onto some international issues, 5½ years ago at a hearing—I know it is going back a while now—you made a comment about Japanese banks. You said:

> The Japanese banks, whatever their difficulties, have had five years to make some progress. Now the progress might be slow, but my feeling is that they are in better shape now than they were five years ago.

As you are obviously well aware, the Resona bank, the fifth-biggest bank in Japan, had to admit that its capital adequacy ratio had fallen to around two per cent, which required the Japanese government to tip in money to keep it going. Is this banking problem in Japan part of the reason why the Japanese economy has been so flat? If so, what are the implications for our trade with Japan, given what is happening to its banks?

Mr Macfarlane—Yes, the weakness of their banking system is one of the reasons why the Japanese economy has been so flat. Remember that, even if it did not have problems, the Japanese economy will not grow very fast. Japan is facing a decline in its working-age population. With a declining working-age population, the only source of growth is productivity growth. As a very mature economy it will not have a lot of that. It may well be that, even if Japan were firing on all cylinders, it would only be growing 1½ per cent per annum. Maybe that is an optimistic assessment of how fast it would grow. That is the first part of my answer.

The second part of my answer is that we have been very fortunate in this country in that, even though our biggest trading partner has had an appallingly bad decade, our exports to our biggest trading partner have done reasonably well. They have grown much faster than the Japanese economy. I do not know what the exact numbers are or whether anyone can remember them, but we have done remarkably well in our exports to Japan. In addition, one of the other weaknesses in Japan is the shifting of its manufacturing base to China and elsewhere. Some of the exports that would formally have gone to Japan, we are still making, but they are being made for Japanese subsidiaries in other countries. So I think we have probably been just plain lucky that our exports have managed to hold up so well. It makes the achievement of the last 10 years all the more remarkable—that we have managed to grow as well as we have, despite the fact that our biggest trading partner has made very little contribution through its own economic growth.

CHAIR—On another area, the Basel II recommendations for capital for banks, which is, I believe, to come in in January 2007, means that, for a lot of banks, the capital will have to be increased. What impact is that likely to have in Australia?

Mr Macfarlane—I think what it means is a literal interpretation of Basel II. Because our banks are quite sophisticated and would be able to use the most sophisticated alternative available to them, it would result in a decrease in bank capital, not an increase.

Mr Stevens—For the big banks.

Mr Macfarlane—For the big banks—for the sophisticated ones that can take advantage of the particular channel. But there are a number of problems with Basel II which I will not bore you with. We are not sitting on the edge of our seats hoping for it to come in quickly; we are quite pleased that it will not be in until 2007. By that time, it probably would have changed another five times, because it changes every time I look at it.

Ms BURKE—We talked earlier in this area about the international Financial Stability Forum that you are a part of. One of their recommendations has been that the central banks publish statistics or reports on the vulnerability of their countries to external shocks. New Zealand has produced one of these reports and has made some statements that, yes, they are vulnerable. Given that New Zealand banks are our banks and that Australia has not produced one of these reports, do you intend to produce a vulnerability report? If not, why not? If you are going to produce one, what do you think it might tell us?

Mr Macfarlane—I think that what you are referring to is a thing called an FSAP—a Financial Sector Assessment Program. These are produced by the IMF at the suggestion of the Financial Stability Forum. This is one of the outgrowths of the Asian crisis. The Financial Stability Forum and the IMF said that one solution would be to establish a whole lot of codes that countries could be assessed against, and one of these is this FSAP. We are perfectly happy to have one whenever the IMF want to come and do it, and we have made it clear to them from the beginning. But the IMF can only do a certain number per year. We are on their list but we are a fair way down their list, because they tend to go to the more vulnerable countries first. So a lot of the big countries like the US, for example, and us—and probably a whole lot more I cannot think of—have not had one. But we are only too happy to have them here and do it whenever they want to.

Ms BURKE—Would you say the New Zealand one we made reference to was one of those?

Mr Macfarlane—Yes, it was. It was one of those.

Ms BURKE—It was not something they just initiated out of their own view of looking at what their vulnerability was?

Mr Macfarlane—When people started talking about this a number of years ago, a number of countries did a voluntary self-assessment, and we did one of those for ourselves. But it must have been three or four years ago that we did that.

Mr Battellino—We were one of the first to do that.

Mr Macfarlane—We were one of the first to do that, and I think that is another reason why the IMF has put us a fair way down the list. But we were only too happy to do it. I have to say, these things are mainly directed at emerging markets and developing countries. If you want to be cynical, it is a way that the developed countries and the international capital markets keep an eye on what is happening in the developing markets.

CHAIR—I want to come back to a question I have asked in the past about credit derivatives. There has been a massive growth in credit derivatives. According to the British Bankers Association, the level will double by next year, which, depending on how you look at it, is quite large. And, for example, Warren Buffett has described derivatives as 'financial weapons of mass destruction'—a bit of colour. Is there adequate disclosure of the level of credit derivatives being used by Australian financial institutions and is this massive growth a threat to stability?

Mr Macfarlane—This is exactly one of the subjects that I was alluding to when I answered the question from David Cox about how we try to keep on top of all these changes that are occurring. We actually put out a paper in our bulletin a few months ago on the growth of credit derivatives and the implication of the growth of credit derivatives. It is happening here, but on a relatively smaller scale—nowhere near the scale to which it has happened in the US and Europe, but particularly the US. It has happened on an enormous scale there.

There is a fear—I am sure Warren Buffet is one of the people who has this fear—that whilst the growth of credit derivatives enables risks to be shifted and dispersed around the world, maybe it is being dispersed to institutions that are not in a good position to hold it. There certainly has been a fear for some time that the banks, being a little more sophisticated in this than the insurance companies, have bundled up a lot of their credit exposure and sold it to the insurance companies—not to our insurance companies but to some of the big European insurance companies. So this is something that the Financial Stability Forum is looking at very closely. It is something which we monitor. No-one is keeping it secret, but encapsulating what is happening and what the risk exposure is in terms of numbers is very difficult.

You said that some people think there is not enough disclosure. It is very difficult, if you pick up the annual report of a bank, to know just how much risk is involved behind all the numbers they will disclose to you about the credit derivatives they have been selling, essentially. Basically banks sell their credit risk to someone else, who earns an income for taking that credit risk. It is something which we are monitoring closely. We have written an article on it. Again, I do not claim to be the expert on it, but we have a couple of people who are very knowledgeable about it, who have read all the literature on it, who are up to date with it and who know the size of the risk the Australian banking system is running compared to other banking systems offshore.

CHAIR—So you are feeling comfortable at the moment?

Mr Macfarlane—Yes.

Mr NAIRN—Earlier we were talking about housing. One of the other areas which has changed dramatically in the lasts few years is investment in shares, et cetera. I am no great expert in this area. In the margin lending area, there seems to be a fairly substantial increase in activity on the figures that I looked at; you might explain it. Even in the space of two years, if you look at the dollar value increase—the RBA produces the results—the average number of margin calls per day per thousand clients has gone up about four or five times. Is there something happening that a closer eye ought to be kept on? Should the Reserve Bank be saying something about it in to he same way it has provided cautionary advice with respect to investment in property?

Mr Macfarlane—I will hand the technical part of the question to someone else. I am glad you asked that question; it is very interesting. Margin lending for shares is the first cousin of negative gearing for buying property. The difference is, No. 1, when you buy a share, you know the price of it every day. No. 2, if your gearing goes up because your equity is declining, your banker phones you up and makes you put in some more equity the same day. So it is exactly analogous to the negative gearing of property, but it is closely monitored on a day-to-day basis. The problem with the negative gearing of property is that you do not know what the thing is worth and maybe you are going to get a rude shock in two years time—but you will not know it until two years time. If it were a margin loan on shares, you would be reminded of it every day and you can cut your position whenever you want to.

That is all I want to say at this stage but, Rick, do you want to add anything on the orders of magnitude? I think the orders of magnitude are quite small. They are nothing like what we are talking about on investment property.

Mr Battellino—Yes, that is right. The overall orders of magnitude are quite low. We started collecting data on this a few years back, because the industry started to grow. The thing that has come out of it is that the banks are really quite conservative in lending in this area. The maximum they will lend is 70 per cent and, on average, the customers are even more conservative. The average they borrow against their shares is about 50 per cent. We were worried about what would happen—this all started when the share market was going up—when the share market goes down. We have had some reasonable tests of that because a lot of these margin loans were against Telstra shares et cetera, which have gone down a fair way. It turns out that the customers have no trouble making margin calls at all. Even though the number of margin calls has gone up a lot, the system has worked very well. Nobody at this stage seems to be getting into big trouble on this thing, but it is something we are watching very closely.

Mr COX—You took Mr Albanese's question about BPay on notice. Could you take on notice my question about whether the government is, on a reasonable range of assumptions, likely to achieve its fiscal target of balance over the course of the cycle?

Mr Macfarlane—I will take it on notice, but I warn you that I will probably refer it to the fiscal experts in the Treasury. They will tell me exactly how sensitive the budgetary position is to various assumptions about economic growth.

Ms BURKE—Mr Albanese also referred earlier to unemployment. In the *Economist* of May 2003 there is a table listing the figures. The unemployment rates for most countries were as good as or better than Australia's, but our economy is tracking better. We have asked this on a number of occasions. Why, even though we have had strong economic growth, have we paradoxically not matched their employment growth or achieved a lower level of unemployment within our country?

Mr Macfarlane—I do not feel particularly comfortable in answering that one, because I think you could answer it in separate ways. You could have two groups of economists here. We have one of the best experts on the subject in the back there. One would tell you that the reason employment has not grown as fast as you would think, given our terrific economic growth record, is that markets are insufficiently deregulated and there are too many impediments to hiring and firing and what have you, like in Germany. Another group of economists would tell you, no, it is due to the fact that we have not got an active labour market program. I think that is something that you just have to try to sort out amongst group of labour economists and experts in that subject. But you could easily find yourself with two totally opposing views about what is the best way of translating economic growth into jobs growth.

Ms BURKE—Given that one of the terms of reference under the act and the memorandum of understanding with the government about what you look at in setting monetary policy is unemployment, is it something you therefore monitor and have an opinion on? Do you view it as one of the things you do when setting monetary policy?

Mr Macfarlane—Basically, the way we interpret it is that we want to provide sustained economic growth, which is an absolute necessity for getting any employment growth. If the employment outcome is a function of all sorts of things like the minimum wage or the hiring and firing conditions or the award structure, we have no control over that.

Ms BURKE—Given that one of the main drivers of how you set things is inflation and that inflation has stayed fairly stagnant for a long time, is it appropriate that the bank should be looking solely at it, or should we now be opening up the gamut and asking whether other factors drive monetary policy?

Mr Macfarlane—The reason for that goes back to the whole logic of the inflation targeting regime. The reason you have an inflation targeting regime when you do not have an unemployment targeting regime is not because you are not interested in unemployment, not because you think it is unimportant; it is because history has told you that you can achieve a particular inflation rate with monetary policy but you cannot achieve a particular unemployment rate just with monetary policy; it depends on all these other factors. That is why not just Australia but so many other countries have an inflation targeting regime, not an unemployment targeting regime, even though they may be equally or more interested in employment in the long run than in inflation.

Ms BURKE—But is there something outside those two? Have we got to the stage nowadays where we have to ask if there is some other target we need to be looking at?

Mr Macfarlane—For a start, I do not think, for example, that the unemployment rate we have at the moment is the minimum. If we had a more favourable international environment and we could grow faster than we currently are, I think our unemployment rate would go down, that it does have further to go down. But with the environment we are in at the moment, I think it is remarkable that it is where it is.

Ms BURKE—Going back to my very first question, are you still ruling out never giving us the minutes of the RBA hearings and never coming back with broader statements?

Mr Macfarlane—I do not think there is much value in doing that—other than enabling people to get a lot of stories about conflict. I do not think they are going to learn anything more about monetary policy by doing that.

Ms GAMBARO—I want to follow on from Anna's question about the unemployment rate in Australia. My family can vote in Italian elections. One of the questions in a recent referendum related to unfair dismissal—they put it to a referendum. I noticed in the same table that Anna was referring to in the *Economist* of 24 May that the latest unemployment rate in Italy is nine per cent. I guess I am asking you to be subjective, but what part do you think inflexible labour reforms play, particularly if this sort of thing is going to a referendum?

Mr Macfarlane—This is interesting: when both of you looked at the same table, one noticed the countries that had unemployment rates below ours and the other noticed the ones that had unemployment rates above ours.

Ms GAMBARO—That is why we are here—for a balanced view.

Mr Macfarlane—Most of Europe has unemployment rates well above ours. There are a few exceptions, but even then you have to look very closely. Some of the countries that have low unemployment rates have an incredible number of people on disability pensions, and if you were to put the two together you might get a fairer assessment. You are bringing me back to the same thing Anna Burke mentioned. There is some evidence around the world that stringent unfair dismissal rules lead to higher levels of unemployment. This used to be summarised by people who contrasted the huge growth of employment occurring in America with the almost zero growth of employment occurring in Europe and said that the country that fires the most hires the most. That is why it is a big issue in some of these European countries. I think there is recognition that it enormously reduces the flexibility of their economies, and it makes firms very reluctant to hire if that flexibility is taken away from them. Once again, I am not an expert on the subject, but certainly a lot has been written about the capacity for creating jobs in countries with flexible labour forces and the difficulty of creating new jobs in the heavily regulated European economies.

Ms GAMBARO—Thank you.

CHAIR—I think we have had a very good innings. Before we close, there is one question I feel I should ask. Looking at the longevity of Alan Greenspan, does that mean being a central banker gives you a healthy future?

Mr Macfarlane—I think chairman Alan Greenspan will be in his 80s when he finishes his final term. That is pretty old, isn't it?

Ms BURKE—You are not looking for the same reign?

Mr Macfarlane—I think that would be an awful result.

CHAIR—Mr Macfarlane, Mr Stevens, Dr Edey and Mr Battellino, thank you very much for appearing before the committee. Thank you to everyone who has come along today. I hope it has been of some value and of considerable interest to you. Thank you also to Hansard and to my committee colleagues.

Resolved (on motion by **Ms Burke**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 12.51 p.m.