The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2004

(Second Report)

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

September 2005
Canberra

ISBN 0 642 786631

Contents

Foreword

The committee's August 2005 public hearing with the Governor of the Reserve Bank of Australia (RBA and the Bank) was the second meeting for the House Economics Committee in the 41st parliament. The RBA continued to report on a healthy economy which is in its fourteenth year of continuous growth. Earlier in the year, the RBA was concerned about the economy over-heating and responded by raising rates in March 2005. At the August hearing, the Bank reported on an economy where the risks are now balanced rather than being on the up side.

The August hearing came at a time when interest rates had risen by 25 basis points in March which ended a 15 month period of no changes to official rates. While there was much speculation surrounding the February hearing regarding an imminent rise in rates the August hearing did not attract similar speculation; on the contrary, many media commentators were predicting a period of no further upward movement with some even suggesting rates may fall before the end of the year. Where interest rates will be at the end of the year and forecasts for inflation were central to the discussions. Other issues examined at the hearing included the relationship between housing prices and household expenditure, the prospects for the global economy and what steps have been taken to address some of the capacity constraints. The committee also sought an update on the reform agenda of the payments system.

The evidence given at the hearing enabled the committee to examine further the setting of monetary policy as well as discuss other aspects of the economy not directly under the control of the RBA.

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

At the hearing, the committee welcomed school students and their teachers from the Melbourne metropolitan area. It was gratifying to see students of economics taking an interest in monetary policy and the role of the Reserve Bank.

On behalf of the committee, I thank the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane, for his discussion and for the contribution of his staff. The committee also appreciates the pre hearing briefings from Dr Alan Oster from the National Australia Bank and Mr Bill Evans from Westpac. I also appreciate the hard work of the Deputy Chair Chris Bowen and our fellow committee members and that of our secretariat staff and advisers.

The Hon Bruce Baird MP
Chairman

Membership of the Committee

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

Committee Secretariat

A/g Committee secretary	Mr Peter Keele
Adviser	Mr David Richardson
Administrative officer	Ms Natasha Petrovic

Terms of reference

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

The focus of the hearing was on the following documents:

- the *Reserve Bank of Australia annual report 2004* which was tabled in the House of Representatives on 17 November 2004
- the *Payments System Board annual report 2004* which was tabled in the House of Representatives on 30 November 2004
- *Statement of Monetary Policy*, Reserve Bank of Australia, August 2005

List of abbreviations

ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
AIG	Australian Industry Group
ASX	Australian Stock Exchange
ATM	Automatic Teller Machine
CAD	Current Account Deficit
EFTPOS	Electronic Funds Transfer at Point of Sale
GDP	Gross Domestic Product
GNE	Gross National Expenditure
OPEC	Organization of Petroleum Exporting Countries
PSB	Payments System Board
$(US)	American dollars
RBA or the Bank	Reserve Bank of Australia
TWI	Trade Weighted Index

1

Introduction

Background

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

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

---

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

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

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

Scope and conduct of the review

1.4 In the 41st parliament the second public hearing of the House Economics committee with the RBA was held in Melbourne on 12 August 2005.

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

1.6 Before the hearing, the committee received a private briefing from Dr Alan Oster, Group Chief Economist, National Australia Bank and Mr Bill Evans, Global Head of Economics, Westpac Bank. These briefings provided valuable background information for the committee and perspectives on issues for discussion at the public hearing.

1.7 The committee was pleased that the Melbourne hearing was well attended by members of the public and students from secondary schools.

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

1.9 As with the previous committee's reports, this report of this committee's work focuses on matters raised at the public hearing. The report does not repeat the detail in the *Statement on Monetary Policy*,

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

the RBA's annual report nor proceedings of the public hearing. These documents may be viewed through the RBA's website[3] or on the committee's website[4]

3 See: www.rba.gov.au

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

2

Monetary policy and related issues

Overview of 2004-05

2.1 The RBA stated that, throughout 2004 the strong global economy continued to push up commodity prices which in turn provided Australia with a significant stimulus to national income and spending, with the prospect of more to come.[1] Growth remained strong in the US and China over the first half of 2005, and Japan started to show signs of an improvement compared to 2004.[2] On the other hand, growth in the rest east Asia slowed and conditions in the euro region weakened further.[3]

2.2 Domestically, both business and consumer confidence remained high throughout 2004.[4] However, domestic demand continued to grow more slowly in the first half of 2005 than it did in 2004.[5] According to the Governor of the Reserve Bank, the pace of growth in domestic demand had clearly been unstainable in 2002 and 2003 when it was

---

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

2 *Statement on Monetary Policy,* August 2005, p 5.

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

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

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

running at about six per cent.[6] It needed to be brought back to a more sustainable pace and this involved some slowing in consumption.[7]

2.3 Gross national expenditure (GNE) increased by one per cent in the March quarter and by 3.5 per cent over the year ending March 2005, compared to 6.25 per cent over the previous four quarters.[8]

2.4 The RBA reported that on the domestic front, the cooling of the domestic housing market during 2004 was associated with an easing in credit growth to the household sector from the exceptionally high rates seen in previous years.[9] Nevertheless, the growth of credit to both household and business sectors remained high and was still growing at around at 12 per cent at the end of 2004.[10] According to the recent Statement on Monetary Policy, August 2005,

> Households now seem to have entered a phase in which they are consolidating their balance sheets, borrowing less and increasing their spending less quickly than they were a year or two ago. Combined with the mild downturn now underway in the housing construction cycle, the adjustment in consumer spending is helping to put overall growth in domestic demand onto a more sustainable trend….[11]

2.5 Inflationary outcomes for 2004 were higher than expected Mr Macfarlane said, coming in at 2.6 per cent for the year. At the August hearing, Mr Macfarlane restated the situation that inflation had been restrained by the appreciation of the Australian dollar from mid 2001 until the beginning of 2004.[12] Against this development, the Governor noted at both the February and August hearings that inflation was likely to rise because of capacity constraints, rising input prices (including oil) and the likelihood that the dollar would not continue to appreciate. According to the Governor, these signals were very strong in February and there was an expectation that credit was likely to pick up again and as a result, the Bank raised the cash rate by 25 basis points in March 2005.[13]

6 *Transcript,* 12 August 2005, p 3.
7 *Transcript,* 12 August 2005, p 3.
8 *Statement on Monetary Policy,* August 2005, p 25.
9 *Statement on Monetary Policy*, February 2005, p 3.
10 *Statement on Monetary Policy*, February 2005, p 3.
11 *Statement on Monetary Policy,* August 2005, p 1.
12 *Transcript,* 12 August 2005, p 3.
13 *Transcript,* 12 August 2005, p 3.

2.6 By the middle of the year, there was some evidence that the earlier tightening may have had a quicker effect than expected and that there was no longer an upward risk to the Bank's inflation forecast.[14]

Forecasts for 2005-06

2.7 The RBA stated in its February 2005 Statement that after a strong year in 2004 it is expected that the world economy will continue to grow in 2005 at an above average pace but not as strong as was experienced in 2004.[15]

2.8 At the August hearing, the Governor of the Reserve Bank stated that the global expansion which has been going for about 3.5 years will continue for a good while yet.[16] Most private forecasters, according to the Reserve Bank, believe that economic growth for the remainder of 2005 and 2006 will continue at above averages rates; albeit not as strong as in 2004.[17]

2.9 Back in February 2005, the Governor outlined in his opening remarks to the hearing, Australia was now into its fourteenth year of expansion and, as would be expected, there is much less spare capacity today than was the case in the early phases of expansion.[18]

2.10 Annual growth averaged 3.7 per cent for the past 14 years prior to 2004. Throughout 2004, growth forecasts were revised downwards. The actual figure for the year ending December 2004 came in at 1.5 per cent.[19]

2.11 At the February 2005 hearing, Mr Macfarlane suggested that the slowdown in growth is explained by the supply side of the economy.[20] A good deal of his subsequent discussion went into the nature of those constraints. He went on to say that demand could not be sustained at the recent levels and if it continued to outpace output growth then the Australian economy would risk rises in inflation.[21]

14 *Transcript,* 12 August 2005, p 4.

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

16 *Transcript,* 12 August 2005, p 2.

17 *Transcript,* 12 August 2005, p 2.

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

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

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

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

He said that there are signs that demand is starting to slow and gross domestic product (GDP) growth will be in the range of 2 to 3 per cent rather than 3 to 4 per cent for a period of time.[22]

2.12 Mr Macfarlane told the committee back in February 2005 that there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances that have got the economy into trouble in the past.[23]

2.13 In August, with two sets of more reassuring price data, the Bank is now able to conclude that the CPI increase will peak at three per cent in the second half of next year – and the crucial word there is "peak".[24]

2.14 The risks, according to the Governor of the Bank, are now balanced rather than being on the up side.[25] Mr Macfarlane stated that while the Bank expected inflation to rise over the coming year, it is of very small orders of magnitude and compared to the past….. "this is nirvana".[26]

2.15 According to the Reserve Bank Board, the current economic situation has been characterised by a number of favourable developments. These include:

- Slowing in domestic demand to a more sustainable trend;
- Households have entered a period of balance sheet consolidation;
- National income is still being boosted by Australia's favourable terms of trade;
- Farm sector prospects have risen following recent rains; and
- Economy is operating at high levels of capacity utilisation and is growing at a manageable pace.[27]

2.16 Against this background, the Reserve Bank Board has come to the view that the medium term inflation risks are not as high as they were at the beginning of the year.[28]

---

22 *Transcript*, 18 February 2005, p 4.
23 *Transcript,* 18 February 2005, p 5.
24 *Transcript,* 12 August 2005, p 4.
25 *Transcript,* 12 August 2005, p 5.
26 *Transcript,* 12 August 2005, p 5.
27 *Statement on Monetary Policy,* August 2005, p 3.
28 *Statement on Monetary Policy, August* 2005, p 3.

Inflation targeting and monetary policy

> In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time.[29]

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

> On inflation: our forecast of a year ago for underlying inflation in the four quarters to December 2004, was 1.5 per cent. At our June meeting here in this building in Sydney with the committee, we had raised it to 2 per cent. In the event, underlying inflation came in at 2 ¼ per cent while the headline figure was 2.6 per cent.
>
> Looking ahead, we forecast gradual rises in underlying inflation, with it reaching 2 ½ per cent by the end of this year and three per cent by end of 2006...[30]

2.18 Mr Macfarlane stated at the August hearing that even though the Bank did not revise its inflation forecast, this movement is not major; in fact he said that when the Bank sits down and does its inflation forecast the figures come out within this quite small band.[31]

2.19 The February hearing devoted a considerable amount of time to the question of where interest rates were heading over the medium term. Media attention at that time also focussed on the issue of interest rates. Many commentators were predicting another rise of 25 points as early as March 2005 with some going further and suggesting another rise of 25 points by the middle of the year. If anything, media attention around the time of the August hearing focussed on the possibility of a sustained period of no further changes to rates or, in some cases, even the possibility of a fall. However, Mr Macfarlane stressed that,

> We have not rung the bell. We think that there is a 50 per cent chance we may have to go up again and a 50 per cent chance

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

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

31 *Transcript*, 12 August 2005, p 5.

> we may go down again. I just want to make people aware of that…..We felt six months ago that there was definitely more than a 50 per cent chance that it had not finished; now we think there is about a 50 per cent chance…..So I think it is a big mistake for people to think that once you are not actually contemplating the next tightening there will be no more tightenings.[32]

2.20 At the August hearing, committee members were keen to follow up with the Reserve Bank their methodology for forecasting inflation given that the Bank's monetary policy is very much based on inflation targeting. Mr Macfarlane explained that two to three per cent band for inflation is not an end in itself but the maintenance of low inflation is a necessary condition for having a long economic expansion in output and employment.[33] Looking back at the March 2005 rate rise, the impact may have been a lot quicker due to the intense media coverage and the fact that households are carrying higher levels of debt and need to service that debt. [34]

Exchange rates and external trade

2.21 At the hearing in February, over a 12 to 18 month period, according to the Governor, a change in the exchange rate can be the biggest influence on inflation, that is, an appreciating dollar will help keep inflation down, but once the dollar settles at a new level, and this impact on inflation dissipates.[35]

2.22 When asked at the August hearing about the likely impact of a depreciating dollar on an inflation-targeting monetary policy, Mr Macfarlane stated that the bank has to look behind the movement in the exchange rate and look at underlying domestic costs and prices.[36] In reference to the recent movements in interest rate, the Governor said,

> During the period when we have been raising interest rates…..measured inflation was quite low because the exchange rate shot up. Someone could have come along and

32 *Transcript,* 12 August 2005, p 6.
33 *Transcript,* 12 August 2005, p 3.
34 *Transcript,* 12 August 2005, p 4.
35 *Transcript*, 18 February 2005, p 7.
36 *Transcript, 12 August 2005, p 21.*

> say, "Inflation is below two per cent; you should be easing." We used the argument that you had to look beyond just the straight figures for inflation and you had to look at what the underlying movements in domestic costs and prices are, because that rise in the exchange rate is going to stop at some point. And even if it does not go down, if it merely stops going up, then all the downward pressure that it has been exerting on inflation will melt away and you are left with whatever the underlying rates of increase in domestic costs and prices are.[37]

2.23 If you responded solely to exchange rate movements you would end up with a very destabilised monetary policy and a very destabilised economy, according to the Reserve Bank Governor.[38]

2.24 Interestingly, the Governor said that he was unable to explain why the terms of trade had risen faster than the trade weighted index (TWI) over the last two years. Normally one would expect a very close relationship between the two but the fact the dollar had not risen as much could simply be a matter of good luck.[39] It may have arisen because people believed that the rise in our terms of trade was only going to be short-lived; whereas in fact, it has continued to rise and this has resulted in a very big increase in real incomes in Australia.[40]

2.25 The Governor stated last February that what is disappointing about Australia's current trade position is that we have been unable to match the world growth in demand for raw materials and manufactured goods even though our terms of trade gain over the last 2-3 years has been of the order of 20-25 per cent.[41] He noted that there has been an increase in competitiveness for manufactured goods because of China's presence in the world market and this has had a downward pressure on prices for such goods.[42] Australia has run into some major bottlenecks that have resulted in an inability to increase supply (volume) to satisfy this demand for basic materials.

37 *Transcript,* 12 August 2005, p 21.

38 *Transcript,* 12 August 2005, p 21.

39 *Transcript,* 12 August 2005, p 21.

40 *Transcript,* 1 2 August 2005, p 21.

41 *Transcript,* 18 February 2005, p 21; *Statement on Monetary Policy*, February 2005, p 37.

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

2.26 In August 2005, the Governor thought that the widening of the CAD reached its peak in the March quarter of 2005.[43] Further signs of an improvement were evident in June as evidenced by a slowing in domestic demand (ie. less pressure on imports), continued lift in the terms of trade (taking $1billion off the trade deficit as it fed through in April, May and June) and there is evidence that export volumes have picked up.[44]

2.27 Mr Macfarlane said that the trade deficit would continue to improve having come off a peak of seven per cent of GDP a few months ago and is now running at around 6.25 per cent and is likely to fall further.[45] If the CAD stays within a particular range, then it is expected that the ratio of debt to GDP flattens out notwithstanding the fact that we still continue to incur monthly trade deficits.[46]

2.28 Buoyant global demand conditions and large increases in contract prices for iron ore and coal have pushed the RBA index of commodity prices to a 23 year high.[47] Following on from earlier increases in contract prices (70% for iron ore and 120% for coking coal) further increases in $(US) terms have been reportedly achieved in the three months to June 2005 of 57 per cent for iron ore and 54 per cent for coking coal.[48]

2.29 On the other hand, the value of manufactured exports increased by only 7.5 per cent over the year to June 2005.[49]

United States and the global economy

2.30 The US economy continued to grow throughout 2004-05 achieving a GDP growth rate of 3.6 per cent.[50] US house prices continue to rise rapidly and this is underpinning a historically high investment in dwellings.[51]

43 *Transcript,* 12 August 2005, p 18.
44 *Transcript,* 12 August 2005, p 18.
45 *Transcript,* 12 August 2005, p 18. *Statement on Monetary Policy,* August 2005, p 41.
46 *Transcript,* 12 August 2005, p 18.
47 *Statement on Monetary Policy,* August 2005, p 43.
48 *Statement on Monetary Policy,* August 2005, p 44.
49 *Statement on Monetary Policy,* August 2005, p 42.
50 *Statement on Monetary Policy,* August 2005, p 5.
51 *Statement on Monetary Policy,* August 2005, p 6.

2.31 Unlike Australia, the Federal Reserve continued to raise rates through out the period rising to 3.25 per cent in June 2005 with the possibility of more rises to come.[52] This has resulted in rates rising by 225 basis points since June 2004.[53]

2.32 Interestingly, no mention was made by the RBA at the August hearing whether this continued rise in US rates would eventually increase the pressure on the RBA to increase rates at home.

2.33 Following on from a statement made by Governor Macfarlane at the February 2005 hearing, he restated his view in August 2005 that the US current account deficit has been financed relatively easily due to the more than adequate supply of world savings.[54] Contrary to some views, the financing of this deficit has not put downward pressure on the $(US) but rather, over the past 12 months the $(US) has risen.[55]

2.34 The Governor of the Reserve Bank was quick to point out that the world economy was not in a parlous state as a result of a number of events such as rising oil prices.[56] On the contrary, even with oil prices rising above $(US) 60 a barrel, forecasts are for world growth of 4.25 per cent in both 2005 and 2006 which is still above the historical average.[57]

2.35 In the Asia pacific, Japan is showing signs of a revival with positive growth of 1.2 per cent in the March quarter and consumer and business sentiment suggest that this expansion may prove to be a bit more durable.[58]

2.36 The Chinese economy continued its rapid expansion into 2005 with real GDP reportedly growing at around 9.5 per cent over the year to June 2005 with industrial production also growing by 17 per cent compared to 14 per cent in 2004. [59] Mr Macfarlane did not see this rate of growth as a potential risk and with the recent changes to its exchange rate regime, although small, will improve its prospects at the margin.[60]

---

52 Statem*ent on Monetary Policy*, August 2005, p 7.

53 *Statement on Monetary Policy* ,August 2005, p 19.

54 *Transcript,* 12 August 2005, p 2.

55 *Transcript,* 12 August 2005, p 2.

56 *Transcript,* 12 August 2005, p 2.

57 *Statement on Monetary Policy,* August 2005, p 5.

58 *Statement on Monetary Policy,* August 2005, p 7.

59 *Statement on Monetary Policy,* August 2005, p 8-9.

60 *Transcript,* 12 August 2005, p 2.

2.37 The rest of east Asia also continues to grow but not at the rate of China. Real GDP for the region increased by 3.8 per cent over the year to the March quarter.[61]

2.38 Europe remains the only disappointing region with euro-wide GDP growing by only 1.4 per cent over the same period and this growth was mainly attributable to a fall in imports, with no growth in domestic demand.[62] Spain was the only major euro economy to go against this trend.

2.39 At the August hearing, Mr Macfarlane said that Latin America, the Middle East, the former Soviet Union and even Africa are performing reasonably well.[63]

Oil prices

2.40 The Governor of the Reserve Bank expressed some concern about oil prices but noted that the rise was primarily due to strong world demand and not to supply restrictions as was the case with OPEC1 and OPEC2.[64] He also added that these rises do not appear to have added very much to inflation or inflationary expectations and therefore not required a specific policy (world wide) response.[65]

2.41 In particular, as oil prices have risen, the Australian dollar has been rising and this has cushioned the effect.[66] Secondly, oil prices have risen proportionally less than they did back in OPEC1 and OPEC2.[67]

2.42 The Reserve Bank Governor explained that because petrol consumption is only around four per cent of people's consumption, a 10 per cent rise in petrol is only going to reduce spending capacity by 0.4 per cent.[68] Further, because we are now in a more competitive environment, oil price rises are not being passed on, and hence

61 *Statement on Monetary Policy,* August 2005, p 9.
62 *Statement on Monetary Policy,* August 2005, p 11.
63 *Transcript*, 12 August 2005, p 2.
64 *Transcript,* 12 August 2005, p 2.
65 *Transcript,* 12 August 2005, p 2.
66 *Transcript,* 12 August 2005, p 14.
67 *Transcript,* 12 August 2005, p 19.
68 *Transcript,* 12 August 2005, p 14.

inflationary, but rather a reduction in purchasing power or reduced profitability.[69]

2.43 When asked directly at what point would the Bank need to tighten monetary policy as a result of rising oil prices, the Governor said,

> We look at several measures of inflation. The main one, obviously, is the headline inflation, which includes the effect of oil prices, and our long-run average is set in terms of that. Over the shorter periods - over a period of 18 months – if, for example, the only reason inflation was going up to an unsatisfactory level was because of a rise in oil prices and the rest of the consumer price index was behaving itself, then that would enter into our thinking on it. That would be an argument for probably not mechanically reacting to the increase in the CPI caused by oil prices.
>
> The other thing you have to remember is that it is only when oil prices are going up that it affects the CPI. If they reach a high level and stay there, then, after a quarter or two, that will no longer be having an effect on the rate of change of the price level or, in other words, on inflation. So we do not mechanically just look at inflation and ignore the parts. We definitely do deconstruct it into two parts and that does affect our decision.[70]

2.44 Oil prices will impact on industries differently. Airlines all round the world will be hit severely by increases in the price of oil. However, according to the Reserve Bank Governor, Australia as a whole will benefit from oil price increases because it is a net energy exporter.[71] The only down size from global price rises in oil is the possibility of a slowdown in growth in the rest of the world but this is unlikely at this stage because the price rises in oil are demand driven and as indicated above, above average economic growth throughout most of the world will continue for some time to come.[72]

69 *Transcript,* 12 August 2005, p 14.

70 *Transcript,* 12 August 2005, p 16-17.

71 *Transcript,* 12 August 2005, p 20.

72 *Transcript,* 12 August 2005, p 2.

Housing and household debt

2.45 In its Statement on Monetary Policy in February 2005,the RBA stated,

> Over the six months to December, housing credit grew at an annualised rate of 12.5 per cent, down from 22.5 per cent over the second half of 2003. Within the total, investor loan approvals and credit have slowed much more than the owner-occupier components...[73]

2.46 In its latest statement, the RBA notes that lending for housing remains above its 2004 average, but has softened in recent months with the value of monthly housing loan approvals falling from a high of $14.1 billion in February to $13 billion in May 2005.[74] The annualised rate for housing credit in the six months to June 2005 came in at 10.9 per cent which is around half the peak rates seen in late 2003.[75]

2.47 Debt servicing ratios are still running at record levels with debt growth continuing to outpace that of income, but there are signs that this growth is staring to slow.[76]

2.48 The Governor noted that during periods when house prices are rising rapidly households tend to react to this by increasing their consumption faster than their income; that is, they reduce their savings. This is generally achieved by reducing discretionary saving or by borrowing against the equity in their house (housing equity withdrawal).[77] This was particularly noticeable in Australia in 2002 and 2003. Since housing prices have come off the boil, the equity withdrawal seems to have stopped. Another way of looking at this trend is to compare the growth in retail sales in the 18 months to December 2003 when house prices were rising (10 per cent) to rates when house prices have been flat over the latest 18 month period (4.5 per cent).[78]

2.49 The pace of growth in domestic demand had been clearly unsustainable in 2002 and 2003 and had to be brought back to more sustainable levels.[79] The Governor clearly welcomed this period of

---

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

74 *Statement on Monetary Policy,* August 2005, p 28.

75 *Statement on Monetary Policy,* August 2005, p 28.

76 *Statement on Monetary Policy,* August 2005, p 27.

77 *Transcript,* 12 August 2005, p 2,3.

78 *Transcript,* 12 August 2005, p 3.

79 *Transcript,* 12 August 2005, p 3.

consolidation nevertheless, the Bank will be monitoring very closely this relationship between housing and household spending because it has become an important influence on our economic development.[80]

2.50 According to the National Australia Bank, the impact of the housing wealth effect on consumption still has a way to go. The move in housing prices from around 22 per cent at the end of 2002 to 10 per cent by mid 2004 to zero at the present point in time could be expected to lower consumption by the best part of 2.4 per cent and GDP by around 1.5 per cent.[81]

2.51 A great deal of attention was devoted to this relationship as it related to the economic performance of various states. Mr Macfarlane believed that house prices are not going to pick up for some time and this is a good thing because previously prices rose to such a level that affordability has become a real issue in particular markets such as Sydney and it was impacting badly on people in the investment sector.[82] In particular, given the size of the boom we had, the Governor was of the view that it is going to take a lot longer to correct this market than just the past 18 months.[83]

2.52 Asked whether NSW was performing poorly because of specific state policies, the Governor said that NSW has distinguished itself from other states over the past five to 10 years because it had had a bigger boom period and, as a result, is suffering a bigger downturn.[84] Notwithstanding the fact that housing prices have retreated in NSW, Sydney is still enormously more expensive than any other city in Australia.[85] Sydney house prices are still 50 to 60 per cent higher than Melbourne and other cities despite the fact that prices are down in Sydney and still rising in most other cities therefore the last thing Sydney needs is some stimulus to getting house prices up and running again.[86]

2.53 The Governor of the Reserve Bank said he did not share the view of others that have emphasised specific NSW state government policies (eg. vendor tax) as being in some way responsible for the downturn in

80 *Transcript,* 12 August 2005, p 3.

81 Statistics presented by Dr Alan Oster, National Australia Bank, to the committee, 11 August 2005.

82 *Transcript,* 12 August 2005, p 6,

83 *Transcript,* 12 August 2005, p 7.

84 *Transcript,* 12 August 2005, p 10.

85 *Transcript,* 12 August 2005, p 11.

86 *Transcript,* 12 August 2005, p 11-12.

house prices.[87] The main reason for the greater volatility in Sydney prices stems from the fact that the prices levels in Sydney are so much higher (and hence affordability) than anywhere else in Australia.[88] This situation has led to a slow down in population growth in NSW because older people are cashing out their valuable asset and moving somewhere cheaper and young people are being forced to find other locations that are more affordable.[89]

2.54 Regardless of where house prices are moving at the moment, the ratio of capital city house prices to annual earnings is around 10 in NSW and between five to eight in the other states and territories.[90]

2.55 The new median house price series which takes greater account of the stratification of all sales within the different groupings in each city confirmed the comments above. In particular, the series confirmed a marked cooling in nationwide house price growth over the past 18 months (zero) compared to around 30 per cent over the previous 18 month period to December quarter 2003.[91] Further, the break down by city showed Sydney falling by seven per cent while Perth put on another 19 per cent clearly benefiting from the strength of the resource sector.[92]

2.56 Towards the end of the recent credit cycle, fierce competition amongst lenders resulted in a lot of discounting which saw around 80 per cent of new loans being discounted by about 50 basis points.[93] Mr Macfarlane said the Bank was taking this into account including its last decision to tighten.[94] If this continued credit standards would be lowered and the debt servicing ratios would rise. The buffer built into loans is likely to get smaller and smaller and hence many lenders will be adversely affected by even the smallest upward movement in rates. Remarkably, according to APRA stress testing, mortgage delinquencies in Australia have been exceptionally low over the past 15 years.[95] However, according to Mr Macfarlane this cannot go on forever and things will need to change.[96]

87 *Transcript,* 12 August 2005, p 13.
88 *Transcript,* 12 August 2005, p 13.
89 *Transcript,* 12 August 2005, p 11.
90 *Transcript,* 12 August 2005, p 12, *Statement on Monetary Policy,* August 2005, p 38.
91 *Statement on Monetary Policy,* August 2005, p 36.
92 *Statement on Monetary Policy,* august 2005, p 36-37.
93 *Transcript,* 12 August 2005, p 8.
94 *Transcript,* 12 August 2005, p 8.
95 *Transcript,* 12 August 2005, p 8.
96 *Transcript,* 12 August 2005, p 8.

2.57 In the Statement on Monetary Policy, August 2005, the Bank stated that credit continues to grow faster than nominal income, which suggests that interest rates are not overly constraining demand for credit.[97] However, in relation to households, the Bank reported that,

> …the six–month-ended annualised rate of household credit growth continued its downward trend that began in late 2003, reaching 10 ¾ per cent in June. The downward trend in household credit growth largely reflects developments in housing credit. Growth in the smaller non-housing personal component has also moderated from its recent peak in January 2005, to an annualised rate of 10 ½ per cent over the six months to June. This is consistent with the decline in personal loan approvals, and mainly reflects falls in fixed term lending, though the revolving component has also contributed.[98]

2.58 In its August Statement, the RBA noted that the earlier long boom in house prices was accompanied by a sharp rise in residential building activity.[99] Given the current cooling in prices it is not surprising that the number of nationwide private residential building approvals fell by 11 per cent over the 18 months to June 2005.[100] At the same time nationwide retail sales only increased by 4.5 per cent in the 18 month period to June 2005 compared to 10 per cent over the 18 months to December 2003.[101] As expected, on a state by state basis, activity varied with NSW and the ACT very weak while Western Australia was strong.[102]

2.59 According to the RBA, the correction in the housing market appears so far to have gone smoothly and domestic demand has not dropped greatly because of the boost to national incomes coming from Australia's favourable terms of trade. [103]

97 *Statement on Monetary Policy,* August 2005, p 57.
98 *Statement on Monetary Policy,* August 2005, p 57-58.
99 *Statement on Monetary Policy,* August 2005, p 38.
100 *Statement on Monetary Policy,* August 2005, p 38.
101 *Statement on Monetary Policy*, August 2005, p 38.
102 *Statement on Monetary Policy,* August 2005, p 38.
103 *Statement on Monetary Policy,* August 2005, p 39.

Australian share market

2.60 Mr Macfarlane commented last February that he thought it was a good thing that people started moving from housing to shares in 2004. [104] This occurred in part due to the housing equity withdrawal in 2002 and 2003.[105]

2.61 At the time of the May Statement on Monetary Policy, the Australian share market had fallen to its lowest level for the year but by July 2005 the ASX 200 had risen by 10 per cent to reach a new high.[106]

2.62 Concern was expressed by the committee at the February hearing with respect to the price to earnings ratio (PE) rising to 21 however by the middle of the year the ratio had come in at around16.5 which is a little above the long-term average (15-16).[107]

2.63 Margin lending for the purchase of shares and managed funds rose by seven percent in the June quarter to $18 billion and over the past year by 30 per cent which has been the fastest since 2002.[108] This contributed to one-quarter of the 14 per cent growth in total personal credit over the same period.[109]

Supply side (capacity) constraints

2.64 The committee received an update from the Governor of the Reserve Bank, Mr Macfarlane, on the problems that were emerging from the supply-side constraints. Mr Macfarlane said that when he last spoke about some of the problems relating to capacity constraints, the issue which he touched on briefly, deficiencies in infrastructure got more than its far share of attention. To that extent, he believed it was a good outcome and the Bank will continue to maintain an interest in developments even though it is not their area of expertise.[110]

---

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

105 *Transcript,* 12 August 2005, p 3.

106 *Statement on Monetary Policy,* August 2005, p 50.

107 *Statement on Monetary Policy,* August 2005, p 51.

108 *Statement on Monetary Policy,* August 2005, p 51.

109 *Statement on Monetary Policy,* August 2005, p 51.

110 *Transcript,* 12 August 2005, p 7.

2.65 This issue of bottlenecks had arisen simply because the Australian economy had been growing for 14 years and it would have been most unusual if no sectors were encountering some capacity constraints.

2.66 While the Governor noted that the skilled labour market wage rises have been quite pronounced he acknowledged that overall, wages have been remarkably well behaved for an economy which has been expanding for over 14 years.[111] The latest wage cost index was going up by 3.9 per cent and the Bank has factored some very moderate increases only into its forecast for inflation.[112]

2.67 Capacity utilisation remains at high levels, particularly in the mining sector and a large number of firms claim that output is still being constrained by a shortage of suitable labour.[113]

2.68 Transport infrastructure problems may be the key reason that some of our commodity exports are not growing as fast as would be expected under current world conditions. However the outlook for manufacturing exports is not as promising. In the early part of this decade, manufacturing exports were flat due to the global recession but in recent times with the global economy growing steadily, our rising exchange rate has offset this turnaround.[114] Dr Edey said that it was unlikely in the medium term that manufactured exports would repeat the experience of the 1990s when trade liberalisation expanded trade in both directions.[115]

2.69 Notwithstanding the results of ACCI and Sensis surveys, which suggest a more subdued economic outlook, capacity constraints continue to be reported as barriers to further expansion.[116] However, this appears not to be the case with housing where activity has declined from the levels experienced in earlier periods.[117]

2.70 In line with the observations above, the manufacturing sector has reported weaker conditions compared with late 2004; however recent surveys differ as to the actual and expected business conditions. ACCI-Westpac survey is more optimistic compared to AIG survey.[118]

111 *Transcript,* 12 August 2005, p 5,7.
112 *Transcript,* 12 August 2005, p 8.
113 *Statement on Monetary Policy,* August 2005, p 29.
114 *Transcript,* 12 August 2005, p 19.
115 *Transcript,* 12 August 2005, p 19.
116 *Statement on Monetary Policy,* August 2005, p 30.
117 *Statement on Monetary Policy,* August 2005, p 30.
118 *Statement on Monetary Policy,* August 2005, p 30.

3

Payments system

3.1 The Reserve Bank of Australia has important regulatory responsibilities for the payments system and plays a key role in its operations. These responsibilities include:

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

3.2 In recent years greater attention has been given to the efficiency of the payments system; in particular, looking into the various means of payment and the associated costs of providing and using them. This is particularly important in the retail payments system as over 10 million non-cash payments are made every day.[2]

3.3 On the 24 February 2005, the PSB released draft standards for the EFTPOS and Visa Debit payments systems for public comment. The proposed standards seek to address the distortions in price and costs

---

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

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

of using the different types of payments.[3] The draft standards propose to:

- reduce the EFTPOS interchange fees paid to the merchant's bank from around 20 cents per transaction to around five cents.[4]
- reduce the Visa Debit interchange fee paid to the cardholder's bank from an average of around 40 cents, to a maximum of around 15 cents;[5] and
- remove the current requirement that merchant's accepting Visa credit cards also have to accept Visa Debit cards (it would also formally apply the no-surcharge standard to the Visa Debit scheme).[6]

3.4 The RBA also announced that is did not intend, at the current time, to regulate the American Express and Diners Club card payments system and in return, both American Express and Diners Club had agreed to:

- reword clauses in their merchant agreements that currently prohibit merchants from encouraging cardholders to use another card; and
- publish the average merchant service fee in Australia on a quarterly basis.[7]

3.5 Since the February hearing the committee has had a chance to consult a number of key stakeholders. With the exception of the initial reforms nearly two years ago (lowering of the Bankcard, MasterCard and Visa interchange fees from around 0.95 per cent to around 0.54 per cent of the amount spent which produced savings of around $580 million)[8], there is a difference of opinion, depending on who you talk to, about the draft 24 February 2005 proposals.

3.6 For some, the concern is based around the RBA's need to regulate rather than allow the normal competitive forces to establish appropriate fees and charges. Others are concerned about the staged reform process and the possible advantage this may give to certain stakeholders who will be operating outside of the "designated" areas

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

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

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

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

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

8 *Transcript,* 12 August 2005, p 23, RBA *Bulletin,* August 2005, 67.

of the payments system. Another area of concern, real or perceived, is the possibility that banks will try and recover the reduced interchange fee revenue by other charges. Merchants, whether they are small or large operators, claim that they will be unable to pass on costs to consumers due to the very competitive nature of retailing. Finally, under the existing payments structure, the merchants have already invested a great deal of money in setting up their EFTPOS infrastructure which provides $10 billion in cash out each year to their customers with little or no financial support from the banks. This situation, according to the merchants, will worsen, not improve, under the proposed reforms

3.7 At the August hearing, the Governor, Ian Macfarlane gave a very robust defence of the RBA's reform agenda.[9]

3.8 In summary, the Reserve Bank's case for reform is outlined below:

- The consumers have benefited from the $580 million savings in interchange fees although you cannot prove directly that prices have fallen. This amount represents between 0.1 and 0.2 per cent of consumer expenditure and with the CPI running at 2.5 per cent per annum it is not possible to identify something that is between one-twenty fifth and one-twelfth and a half.[10]
- The net savings is estimated to be around $400 million after you deduct around $180 million for increased bank charges.[11] The cut back in reward benefits cannot be as easily quantified but the Bank estimates that they are considerably less than $180 million. By way of comparison, QANTAS reward points are now worth 0.6 per cent of the value of each transaction compared to 0.8 per cent prior to the reforms.[12]
- In a competitive retailing industry, costs and prices are strongly related, therefore it is inconceivable that a reduction in costs did not have an effect on prices.[13]
- The whole point of the reform process was to make the users of the payments system better off, because the Bank believed that

9 *Transcript,* 12 August 2005, p 23-25.
10 *Transcript,* 12 August 2005, p 23.
11 *Transcript,* 12 August 2005, p 26.
12 *Transcript,* 12 August 2005, p 26-27.
13 *Transcript,* 12 August 2005, p 24.

the providers of payment services were charging too high a price.[14]

- The Reserve Bank says that it is a mistake to assume the consumers are simply cardholders. Consumers include all types of payment forms; including the two types of cardholders - transactors and those who actually borrow against their cards. Consumers also include all the merchants. In aggregate, this group of people are better off to the tune of $580 million.[15]
- The Bank acknowledges that cardholders are not as well off under the reforms because they have suffered a reduction in the subsidy they were receiving. These people were using someone else's credit and not paying for it. The Bank makes no apology for this because they are making the totality better off.[16]
- According to the Bank, one objective of the reform process is to reduce or eliminate the cross-subsidies and ensure the costs incurred by the various payment methods are actually reflected in the price or charge for that particular service.[17] If this results in higher card fee charges and less rewards/inducements then this is the price people will have to pay in order to achieve a more equitable and open payments system.[18]
- The Reserve Bank maintain that some of the allegations about lost market share between those bound by the four-party scheme and those that come under the three-party scheme will only be tested once data is published about the respective market shares.[19] This has now occurred and the Bank in its August 2005 Bulletin published aggregated market shares between the two schemes.[20] The data reveals for the first time that,

  > …that around 83 per cent of the value of purchases on credit and charge cards are currently undertaken with a Bankcard, MasterCard or Visa. These schemes account for a slightly higher share of the number of purchases, reflecting the fact

14 *Transcript,* 12 August 2005, p 24.

15 *Transcript,* 12 August 2005, p 24.

16 *Transcript,* 12 August 2005, p 24.

17 *Transcript,* 12 August 2005, p 24, 27.

18 *Transcript,* 12 August 2005, p 24.

19 *Transcript,* 12 August 2005, p 24-25,

20 RBA *Bulletin,* 12 August 2005, p 69, Table C2, p S28

that the average purchase made through these schemes is lower than the average purchase made through the American Express and Diners Club schemes.[21]

- According to the RBA in its August 2005 Bulletin, most of the recent increase in market share (by value) by the charge cards from 14.6 per cent in June 2003 to 16.5 per cent in July 2004 was largely concentrated in the second quarter of 2004 which coincided with the introduction of the Westpac and National Australia Bank issued American Express cards and market share has not changed significantly since that release.[22]
- These types of "joint/hybrid" cards are not a result of the reform process. They are common through out the world .
- Putting this into perspective, the Bank estimates that the two percentage point increase in share by American Express and Diners would have increased merchant services fees by $44 million but this has already been factored into the cost saving to merchants of $580 million over the same period.[23]

3.9 The committee believes that it is too early to conclude that the increase in market share is just a one-off as a result of the introduction of the bank-issued AMEX cards and/or the co-branded Diners card. It will depend very much on whether merchants are prepared to surcharge or steer customers to less costly cards and this will, in the longer term, determine the extent to which particular cards can continue to offer and pay for the higher rewards schemes.

3.10 In response to concerns that the charge cards operate outside of the designated four-party scheme, the Governor made it very clear that American Express and Diners Club have had to agree to three changes:

- publication of their merchant services fees;
- abolition of the no-surcharge rule (ie. merchants can charge customers extra if a more expensive card is used); and
- abolition of the no-steering provisions (ie. merchants can ask customers to use a less expensive card).[24]

21 RBA *Bulletin,* August 2005, p 69.

22 RBA *Bulletin,* August 2005 p 69.

23 RBA *Bulletin*, August 2005, p 70.

24 *Transcript,* 12 August 2005, p 26.

3.11 The recent publication of merchant fees shows that the combined average Bankcard, MasterCard and Visa has fallen from around 1.46 per cent of purchase value in September 2003 to around 0.97 per cent in June 2005. Over the same period, American Express has dropped from 2.60 to 2.38 and Diners Club has dropped from 2.35 to 2.31.[25]

3.12 Since the commencement of the reforms, many new entrants have entered the credit card market and are now offering cards at far lower interest rates to consumers who actually borrow on a credit card.[26] These cards are giving the credit users a cheaper alternative as apposed to the transactors who pay off their credit balance monthly. The two-thirds of credit card holders who actually borrow are benefiting from the lower monthly interest charges of around 10 per cent as apposed to the more traditional 16-18 per cent and in the process the new entrants are still making money.[27] This has now prompted two of the banks to offer similar low cost cards presumably to retain existing cardholders who do rely on credit and to compete against the new entrants.[28]

3.13 Mr Macfarlane was emphatic that no matter what type of card customers choose to suit his or her needs, it should not be done on the basis of cross-subsidies which ultimately distort the payments system.[29]

3.14 In response to concerns that many retailers are not in a position to surcharge let alone negotiate a lower merchant service fee with their bank, Mr Macfarlane stated that around five per cent are already surcharging and 45 per cent are considering surcharging.[30] The Governor also believed that merchants as a whole have underestimated the power they have at their disposal due in part to over 30 years of restrictions that have been placed on them. They are now in a position where they can start to exert some power.[31]

3.15 Notwithstanding the fact that small retailers possibly have less power to negotiate individually with each credit card provider, many

---

25 RBA *Bulletin*, August 2005, Table C.3, p S29.

26 *Transcript,* 12 August 2005, p 27.

27 *Transcript,* 12 August 2005, p 31-32.

28 *Transcript,* 12 August 2005, p 32.

29 *Transcript,* 12 August 2005, p 27.

30 *Transcript,* 12 August 2005, p 28.

31 *Transcript,* 12 August 2005, p 28.

already do not accept American Express and Diners because of the higher fees.[32]

3.16 In the US where MasterCard and Visa compete in a deregulated market, the interchange fees went up, not down, simply because of the peculiarity and structure of the payments system (surcharging and steering are not allowed). One would raise their fees and in return offer more rewards and the other would compete by doing the same and both would then go to the merchants and raise their fees on the premise that so many people use their cards that they could not afford to opt out of the scheme.[33] The Reserve Bank Governor said that this system defied the normal competition policy theory not because of lack of transparency but because of the unique structure and agreement setting processes. The interchange fee rose from 1.3 per cent in 1994 to 1.65 per cent in 2004 while over the same period the merchant services fee rose from just under 2.0 per cent to slightly over 2.2 per cent.[34]

3.17 If the payments system, and in particular the inter change fee, had been left unregulated in Australia, the Reserve Bank Governor claimed that fees would continue to rise as had occurred in the US where there had been no regulation of the payments system. Mr Macfarlane stated that as difficult as regulation may be, it is the only way to bring about some parity between the cost incurred and prices charged for each payment type within a reasonable period of time. [35]

3.18 Some committee members questioned whether the US experience was rather a consequence of a failure to ensure merchants were allowed to surcharge on particular cards and/or encourage customers to use one card rather than another. In the US (as was until recently the case in Australia) the card companies require that merchants do not surcharge or steer customers away from a particular card. The Reserve Bank Governor, by way of a partial concession, agreed that the big difference between Australia and the US was the inability for US merchants to surcharge or steer customers to less expensive cards.[36] The question which arises therefore is whether the reform objectives could have been achieved in Australia without regulating

32 *Transcript,* 12 August 2005, p 29-30.

33 *Transcript,* 12 August 2005, p 29.

34 Speech by I. J. Macfarlane, Governor of the RBA, *Gresham's law of Payments,* talk to AIBF Industry Forum 2005,Sydney 23 march 2005, p 2-3.

35 *Transcript,* 12 August 2005, p 29-30.

36 *Transcript,* 12 August 2005, p 30.

the interchange fees, but simply by ensuring greater transparency and in particular an ability on the part of merchants to surcharge and steer customers to less expensive cards. Fundamental to this proposition, of course, is the ability and willingness of merchants to exploit their newly gained freedom.

3.19 The reform agenda will enable merchants to improve their bargaining position. The big retailers are in a far better position to negotiate lower merchant services fees. Mr Macfarlane hopes that the smaller retailers will start talking to one another and also improve their bargaining position. After 30 years, merchants are now in a position to adopt the user-pays principle and not feel powerless against the banks and credit card companies.[37]

3.20 The issuers of Visa Debit Cards have also been critical of the reforms because of the reduced revenue they will receive as a result of any lowering of interchange fees. Mr Macfarlane was quick to point out that the Visa Debit card is debit masquerading as a credit card. Card holders are using their own money every time they make a debit transaction but merchants have to pay a fee as though it was the more expensive credit card transaction.[38] According to the Governor, this is a basic case of misrepresentation and should be stopped.[39]

3.21 What is happening to the debit card/EFTPOS industry is central to the payments system reform agenda. Mr Macfarlane said,

> The more fundamental issue is the whole future of the debit card industry or the EFTPOS industry. In Australia at the moment we have this peculiar situation-we are the only country in the world that has it-whereby, if I am a bank and issue you with an EFTPOS card, every time you use it I have actually got to pay money out. But if I issued you with a credit card, every time you use it I receive money in. In the long run what do you think the banks are going to do? In the long run it is in their interest whilst this continues to allow the whole EFTPOS system to dwindle and move everyone into credit cards. Our starting point to this deregulation was very difficult. That is an absurdity which we have in Australia for historical reasons that no-one fully understands

37 *Transcript,* 12 August 2005, p 30.

38 *Transcript,* 12 August 2005, p 31.

39 *Transcript,* 12 August 2005, p 31-32.

> and no-one else in the world has. We have a starting point that is very difficult to deregulate from.[40]

3.22 Interestingly, the Governor told the committee that industry is now asking the RBA to step in and reform the ATM system so it cannot be said that the Bank is hell bent on regulation.[41] The Bank has held back to see if the industry could come up with a workable model but that process seems to have stalled and the Payments System Board will have to decide at its next meeting what the next step will be with regard to issues of transparency of ATM owner charges customers and the transparency of the price that the customer's bank charges.[42]

3.23 Once the reform agenda is firmly established, the Reserve Bank expects that consumers will select the payment system that best meets their specific needs. Hopefully consumers will be able to do this based on the best available information taking into account all the costs, fees and charges that are incurred through the entire transaction chain and not simply on the level of rewards that may be offered.

3.24 The committee will follow carefully the legal challenges to certain aspects of the proposed reforms and will be interested to see how the Payments System Board deals with the ATM system.

3.25 The committee will look at this issue again next year with a view to holding a public inquiry into the reform of the payments system which would involve all stakeholders, including consumers (card users).

The Hon Bruce Baird MP

Committee Chairman

8 September 2005

40 *Transcript,* 12 August 2005, p 31.

41 *Transcript,* 12 August 2005, p 32.

42 *Transcript,* 12 August 2005, p 32-33.

A

Appendix A – Submission

Number	Provided by
1	Reserve Bank of Australia (*Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, public hearing Melbourne, 12 August 2005).*

B

Appendix B – Hearing, briefings, and witnesses

Public hearing

Friday 12 August 2005 – Melbourne

Reserve Bank of Australia

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

Private briefings

Thursday 11 August 2005–Canberra

Dr Alan Oster, Group Chief Economist, National Australia Bank

Mr Bill Evans, Global Head of Economics, Westpac