The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia annual report 1998-99

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

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Contents

Foreword

In this report the Committee continues its review of the Reserve Bank of Australia's annual report for 1998-99 and the first Annual Report of the Bank’s Payments System Board. It also considers the Semi-Annual Statement on Monetary Policy released in May 2000.

The report concentrates mainly on issues discussed in the May 2000 public hearing, which was one of the Committee's biannual meetings with the Governor of the Reserve Bank.

These meetings are assuming a growing importance, as the role of the Bank and management of monetary policy takes on an increasing significance in the Australian economy.

The Australian economy has now enjoyed nine consecutive years of growth and the stability of our monetary policy has been influential in continuing that growth trend. Nevertheless, the Committee has been concerned to see interest rates increased four times in six months.

In undertaking this review of the Reserve Bank's operations, the Committee appreciates the assistance and cooperation given by the Bank’s staff. The Committee has once again been pleased with the level of professionalism demonstrated in their approach to the hearing and in the preparation and presentation of the Semi-Annual Statement for May 2000.

The Committee also appreciates the briefings it received before the hearing from Mr Peter Osborne, Chief Economist with Merrill Lynch and Mr Barry Hughes, Chief Economist with Credit Suisse Asset Management.

During the preparation of this report, the Committee and Secretariat were shocked and saddened to learn of the death of the Deputy Chair Greg Wilton. Greg was a major contributor to the bipartisan approach which this Committee has taken in its inquiries – he will be sadly missed.

I thank all of the members of the Economics, Finance and Public Administration Committee for their contributions to the public hearing and to this report.

David Hawker MP
Chair

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Terms of reference

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

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

The *Reserve Bank of Australia 1999 Report and Financial Statements* (annual report) was tabled in the House of Representatives on 31 August 1999, and the Reserve Bank of Australia *Payments System Board Annual Report 1999* was tabled on 29 September 1999.

List of abbreviations

ACCC	Australian Competition and Consumer Commission
CAD	Current account deficit
CPI	Consumer price index
DoFA	Department of Finance and Administration
EFPA	House of Representatives Standing Committee on Economics Finance and Public Administration
GDP	Gross Domestic Product
GST	Goods and Services Tax
OECD	Organisation for Economic Cooperation and Development
RBA	Reserve Bank of Australia
Y2K	Year 2000

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Introduction

Background

1.1 The Reserve Bank Governor's biannual appearances before the House Economics Committee have become a critical avenue of accountability and transparency for the Bank. Each event is watched closely by the parliament, financial sector and community.

1.2 With the Central Bank's management of monetary policy playing an ever more significant role in the management of the Australian economy, these appearances are not only closely observed nationally but are also of growing international interest.

1.3 The background to these appearances is an agreement between the Treasurer and the Governor on key aspects of Australia's monetary policy framework.[1] The Reserve Bank's Semi-Annual Statements on Monetary Policy, together with the Bank's annual report and the Payments System Board annual report, form the basis for discussion.

1.4 The procedural basis for the Committee's work is House of Representative's standing order 324 (b) whereby annual reports within a committee's area of portfolio responsibility stand referred for any the inquiry the committee may wish to make.

1 Reserve Bank of Australia. *Report and Financial Statements, 30 June 1997*. RBA, Sydney, pp 8-10.

Scope and conduct of the review

1.5 On 2 September 1999 the Committee agreed to review the Reserve Bank's annual report 1998-99.[2]

1.6 This report on the Committee's work focuses on that annual report, the Reserve Bank's *Payments System Board annual report 1999*[3] and the Bank's *May 2000 Semi-Annual Statement on Monetary Policy*.[4] Copies of these reports are available from the Reserve Bank and on its internet site.[5]

1.7 These reports were discussed at a public hearing in Melbourne on Monday 22 May 2000. Details of the hearing are set out at Appendix A. A copy of the transcript of evidence from the hearing has been published by the Committee and is available on its internet site[6] and from the committee secretariat. For the first time there was also a live audio broadcast of the hearing on the Parliament House Monitoring System in Canberra and an audio webcast on the Parliament's internet site.[7]

1.8 Although the Committee does not formally advertise its inquiry in the press, details of the hearing were outlined in the Department's monthly advertisement in *The Australian* newspaper on 3 May, on the Committee's internet site and the hearing received good coverage in the media.

1.9 For the May hearing, the Committee also specifically invited some local university and senior secondary economics students and staff (located in the vicinity of the hearing venue) to attend the hearing. About 100 students attended.

1.10 As with past hearings, prior to the day the Committee held private briefings with two leading economists from the financial sector. They were Mr Peter Osborne, Chief Economist, Merrill Lynch Australia and Mr Barry Hughes, Chief Economist, Credit Suisse Asset Management. Those briefings presented some alternate viewpoints on current monetary policy and the Reserve Bank's handling of that policy.

1.11 The Committee's public hearing addressed monetary policy and issues related to the operation of the Bank. This report covers both matters. It

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2 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999*. RBA, Sydney, p 98.

3 Reserve Bank of Australia. *Payments System Board Annual Report 1999*. September 1999. RBA, Sydney, p 35.

4 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, p 49.

5 http://www.rba.gov.au/report/rp_ind.html

6 http://www.aph.gov.au/house/committee/efpa/rba9899/rbaindex.htm

7 http://www.aph.gov.au/live

focuses on significant matters that were raised at the public hearing but does not repeat the detail set out in the May Semi-Annual Statement nor the Reserve Bank's annual reports. It builds on the Committee's interim report, which was tabled in the House of Representatives in March 2000.[8]

1.12 At the hearing the Chairman was pleased to announce that the next hearing with the Reserve Bank will be held in Wagga Wagga in the Riverina, NSW on 11 December 2000. This will be the first hearing ever to be held outside the metropolitan capitals. It is the result of calls from a number of areas for some time for this to occur.

8 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of the Reserve Bank of Australia Annual Report 1998-99: Interim report,* March 2000, Canberra, CanPrint Communications Pty Ltd, p 46.

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Conduct of monetary policy

Review of forecasts presented in November 1999

2.1 In his opening remarks, the Reserve Bank Governor reviewed the forecasts presented to the Committee by the Bank in November 1999.

2.2 At the November hearing the Governor summarised the outlook for 1999 and the first half of 2000, as follows: GDP growth through calendar year 1999 expected to be 3.5%, rising to 4% for the financial year to June 2000; unemployment expected to fall, to be in the 6% range by June 2000; the CPI to rise by 2% in the calendar year to December 1999 and 2.75% in the financial year to June 2000, with underlying inflation at 2.5%; and the current account deficit (CAD) to remain about 6% of GDP for this financial year.[1]

2.3 Actual results were: GDP growth of 4.3% for calendar year to 1999 (up on the RBA estimate) and looks like being 4% for the financial year to June 2000; unemployment has fallen below 7% of the labour force for the first time in a decade, averaging 6.8% from January to April 2000 and falling again to 6.7% in May; the CPI rose by 1.8% in the calendar year to December 1999 and 2.8% in the year ended March 2000, with underlying inflation currently around 2.25% and expected to rise a little higher to 2.5% for the financial year to June 2000.[2]

2.4 As with the past couple of years of its predictions, the Bank's forecast slowdown in growth in calendar year 1999 did not arrive, but its inflation forecasts were more accurate.

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1 Evidence pp 3 and 46-7.

2 Evidence pp 46-7 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, pp 1, 21, 41 and 49.

Prospects for 2000-2001

2.5 The Bank also discussed its projections for 2000-2001. At the hearing and in its Semi-Annual Statement it stressed that the remainder of 2000 will be unusually hard to interpret because of the influence of tax reform arising from the new tax regime commencing on 1 July 2000 and the Olympic Games.[3]

2.6 Despite these difficulties, in summary, the Bank said it expects economic growth to remain robust, although its composition is changing to rely more on external than domestic demand.[4] It supports the figures contained in the budget papers of growth in GDP of 3.75%.[5] It provided no predictions on unemployment at the hearing but stated in its semi-annual statement that '…Labour market conditions have been tightening over the past year…'[6] Projections of inflation related to the longer term and referred to three time periods: in the second half of 2001, over the coming year to 18 months and in the year 2001-2002. During each of these periods, inflation is expected to be within the 2-3% range and likely to be in the upper half of the range, though the Bank stressed the very large margin of uncertainty.[7]

2.7 The Bank said in terms of economic growth it expects the international environment to remain favourable for the Australian economy, with world growth in 2000 and 2001 expected to be noticeably faster than in 1999. At the same time it expects Australia will be affected by the contractionary effects of increases in world interest rates.[8]

2.8 Overall the Bank's expectations for the next year were optimistic. It said that if the economy:

> …can sustain economic expansion for a 10th and 11th year - even if the pace moderates for a time - and at the same time keep inflation low, we will have achieved something which has eluded us for three decades…'[9]

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3 Evidence pp 46-7 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, pp 2 and 14.

4 Evidence p 46 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, pp 1-2.

5 Evidence p 46.

6 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, p 48.

7 Evidence p 47 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, pp 3 and 49.

8 Evidence p 49 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, p 1.

9 Evidence p 49.

2.9 The Committee also hopes that this can be achieved. It observes that the reforms to Australia's economic structure in recent years, have been a major factor in making such a long stretch of continuous growth possible.

Interest rates and inflation

2.10 The hearing on 22 May 2000, took place less than three weeks after the Reserve Bank had announced the fourth increase in the key interest rate, the overnight cash rate, in seven months. The increases totalled 1.25 per cent (or 125 basis points) and increased the cash rate to 6 per cent. The greater part of the hearing concentrated on the Bank's reasons for this series of increases and related topics.

2.11 The Governor's comments at the hearing indicated that the Bank's primary concern is to ensure that inflation does not bring to a premature end, the long period of continuous growth in the Australian economy – nine years to date.[10]

2.12 Australia has enjoyed a period of very low inflation, aided by strong deflationary influences in some of our important trading partners during the Asian crisis. In these circumstances, the Bank has been able to run a low interest rate regime.

2.13 The recovery in Asia has altered that situation and the Bank has stated that the expansionary monetary policy of 1998 and 1999 is no longer appropriate.[11] In Media Releases announcing the interest rate increases, the Bank referred to indications that the underlying inflation rate is increasing and that credit growth is higher than can be sustained in the long term.[12]

2.14 The Bank's expectation is that the rate of inflation will no longer be below the target range, as it has been for a couple of years, but will move back within the target range of 2-3%. After the initial GST impact has passed and we are well into the year 2001-2, inflation is likely to settle down towards the top of that range.[13]

2.15 In a further reference to the target range for inflation, the Governor commented:

10 Evidence pp 47-8.

11 Evidence p 4.

12 *Monetary Policy*, Reserve Bank of Australia, Media Releases: Nos. 1999-11, 3 November 1999; 2000-3, 2 February 2000; 2000-8, 5 April 2000; and 2000-11, 3 May 2000 – Appendices C to F.

13 Evidence pp 47-8 and 52.

> We accept that at times it will be outside this range. But, if we think that is going to happen more than briefly, it calls for adjustments to monetary policy which will return inflation to the target and then keep it there. We have based our monetary policy on this framework not because we only care about inflation but because we think it will give us the best result for the whole economy in the long run. …[14]

2.16 The Committee noted that in its various media releases (see Appendices C to F) and comments on the recent interest rate increases, the Bank has gradually altered its approach and its description of the state of monetary policy[15].

2.17 For example, in November (Appendix C) the Bank said that monetary policy to that time had been expansionary. It was then described as moving to neutral (Appendix D) but then, in recent media releases, this concept has been ignored. Further, the April release announcing an interest rate increase (Appendix E), introduced the depreciation of the exchange rate as an important factor influencing inflation and, hence, monetary policy. The May release (Appendix F) then seemed to water down this effect.[16]

2.18 The Governor responded that the comments made by the Bank at any given time reflect the economic conditions ruling at that time. As an example, he described the changing economic conditions which led to the transition from an expansionary monetary policy in 1998 and 1999, to a position of more restraint in 2000.[17]

2.19 Interest rates, Mr Macfarlane said, had begun from extremely low levels; rates established in a climate of strong economic growth in the economy as a whole. These conditions had led to very rapid growth in borrowing and there was a need to restrain the growth in credit transactions. This had become an important issue when economic data began to show an underlying increase in inflation.

2.20 The Governor made it clear that the Bank sees the interest rate as an integral part of its inflation control regime. He stated that monetary policy is not used to try to achieve a specific rate of GDP growth, but to keep inflation within the target range.[18]

14 Evidence p 47.

15 Evidence pp 62-3.

16 Evidence pp 62-3.

17 Evidence p 63.

18 Evidence pp 51-3.

2.21 On this occasion, the Bank provided more detail of its strategy in dealing with inflation. It was explained that each time the Bank changed policy settings, the new settings were regarded as "neutral", i.e. the settings which would bring inflation to the middle of the target range. The comment was made that:

> … you are always aiming for the centre of the band; the worst archer still aims for the bull's eye.[19]

2.22 The Governor said that the Bank's attitude to overshooting or undershooting on the target band had never changed. The aim is to have inflation within that band 18 months or 2 years ahead – if possible, in the middle of the band.[20]

2.23 He noted, however, that there were problems in achieving that aim. The Bank cannot forecast perfectly and the economy suffers unforeseen shocks from time to time:

> … we will sometimes find ourselves above the top of the band and sometimes find ourselves below the bottom. We would not regard that in itself as a big deal, unless we thought it was going to stay there for a long time and we were going to have a potentially inflationary situation where inflationary expectations ratcheted up, or a potentially deflationary situation. But, if we are above it or below it for a relatively short period, it does not particularly worry us.[21]

2.24 It has been noted that, while the Bank bases its pre-emptive policy changes, at least in part, on the predicted rate of underlying inflation, it does not systematically publish its estimates for that rate. There is also some confusion on what figures are included in the calculation of underlying inflation.[22]

2.25 The Committee agrees that these issues deserve discussion and will take them up with the Bank at the next hearing in December.

2.26 The economic picture is complicated by the fact that recent published statistics have indicated a slowdown in consumer spending, which has been the main component of economic growth during the past two years. The Governor suggested that it was not yet certain whether this was the much-anticipated modest slowdown in growth or a more fundamental contraction of GDP. He said that the Bank tended to think it was the

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19 Evidence p 52.

20 Evidence p 51.

21 Evidence pp 51-2.

22 *Can Monetary Policy be Made to Work in the New Economy?*, Des Moore, to Economic Society of Australia, Canberra Branch, 31 May 2000, pp 6-9.

predicted modest reduction in consumption growth, with its effects likely to be largely offset by other factors – such as increasing exports and the forthcoming boost from fiscal policy when the New Tax System is introduced on 1 July 2000.[23]

2.27 The Governor commented that to restrain inflation, it was necessary for consumer spending to slow down but he is not convinced that the published statistics give an accurate picture. He said that statistics held by the Bank show a much more positive picture for retail sales:

> … the contraction, I think overstates the situation. It also says that, over the whole year to the March month, retail trade has risen by only one per cent in value terms. If you ask the retailers, they have all got much stronger figures than that. … I think we have seen a slowdown in retail trade but nothing like what is shown in the figures. … on the other hand, I do not doubt that consumer sentiment is more subdued than it was last year and that spending has come down.[24]

2.28 Clarifying his comments on the relationship between interest rates and inflation, the Governor said:

> If inflation stays within its targets, you do not have to do anything. If inflation stays within its target – and if the prospects for inflation are that they will stay within their target – there is no prima facie reason for changing monetary policy for any reason.[25]

Exchange rate

2.29 The Committee raised the question of the relationship between interest rates and the exchange rate, noting that in its recent Media Releases on monetary policy the Bank has begun referring to the exchange rate as a factor in its decisions to increase interest rates.[26]

2.30 The Governor explained that external factors, including the exchange rate, have always been taken into account in the inflation targeting regime. In the last few years, in fact until quite recently, those external factors have been deflationary and so have not impacted on monetary policy. Both the

23 Evidence p 46.
24 Evidence p 50-1.
25 Evidence p 68.
26 Evidence pp 62-3.

recovery in the international marketplace and the recent decline in the value of the $A, have altered that situation.[27]

2.31 The international recovery has produced a change in the composition of Australia's growth, with exports playing a far greater role than in the last two years or so. The decline in the $A has produced inflationary effects that have not been a factor for some time and in the coming months it will also reinforce the surge in exports.

2.32 The Governor noted that the decline in the exchange rate had occurred in two phases. In the first phase, mid-January to the end of March or early April, the $A fell faster against the $US than any other major currency – 10% by the end of April. Since then, in the second phase, the $A has hardly fallen at all and the other major currencies have declined sharply against the $US.

2.33 He commented that the situation now seemed to be resolving itself as a general decline in the face of a very strong $US. That situation, he said, we can be more comfortable with – "… we are in good company".[28] Later, he added:

> So we may be entering this world, which would not be an unreasonable world, where the US does one thing and everyone else does something different.[29]

2.34 The Committee noted that commodity prices are strengthening and asked what impact this would produce on the $A. The Governor said that the normal effect of rising commodity prices was to strengthen the $A. He cautioned, however, that although commodity prices are strengthening, so far this has not affected the $A. He added that there are a number of factors influencing the value of the $A and the trend in commodity prices is only one of them.[30]

2.35 The Governor was also asked whether the influence of commodity prices on the $A was weakening. The Committee noted that, currently, only 52% of exports were commodities. It suggested that the $A is now seen less as a commodity currency than previously. The Governor agreed but said that the process of change is a slow one.[31]

2.36 There has been some public speculation that the Bank was adopting a policy based on achieving an exchange rate target. Responding to the Committee, the Governor denied this and said the idea sounded like

27 Evidence pp 63-4.
28 Evidence p 65.
29 Evidence p 69.
30 Evidence p 62.
31 Evidence p 62.

"some sort of quasi-fixed exchange rate". He reminded the Committee that Australia's exchange rate had been allowed to vary much more than many countries. He said Australia had received a lot of benefits in the past because the exchange rate was allowed to vary.[32]

2.37 In response to a question on the likely inflationary effect of the decline in the value of the $A, the Assistant Governor (Economic), Mr Stevens, said that historically, a decline of 10% in the exchange rate produced, on average, an increase of 3% in the level of the CPI. Normally, about 1% of this occurred in the first year. He noted that this was a single effect, with the growth rate of inflation being unaffected. He also stressed that this average result had been calculated over a long period. During most of the period covered, inflation was high; consequently, the effect may be less today in a low inflation economy.[33]

2.38 A comment in the Semi Annual Statement indicated that the Bank had not recently intervened in foreign exchange markets.[34] The Committee asked if that was still true. The Governor said that, while the statistics are published monthly, the Bank did not make public comments on whether it had intervened or not. He said the figures showed that they had not done anything in foreign exchange markets.[35]

2.39 This response led to a question on whether the Bank's actions in choosing to provide the Government's foreign currency requirements from reserves and not replacing them through the marketplace, was equivalent to direct intervention – i.e. not selling $A has the same effect in the market as buying them. The Governor agreed that there would be a marginal effect but said he personally would not call it intervention.[36] **The Committee, however, does regard this as a form of intervention.**

2.40 Referring to Australia's recent series of Budget surpluses, the Committee asked what impact fiscal policy had on the exchange rate. The response was, that it depended on the international opinion of your policy. If the international community thinks that the CAD is unsustainable – the exchange rate will suffer. If, as in Australia's case at present, you are in the international "good books", small variations in the surplus do not have any discernible effect on the exchange rate.[37]

32 Evidence p 68.

33 Evidence p 66-7.

34 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000.* RBA, Sydney, p 39.

35 Evidence p 67.

36 Evidence p 77.

37 Evidence p 70.

Fiscal policy

2.41 Links between monetary and fiscal policy are also important and the Bank stressed this link particularly for the medium term. Questions were raised about the RBA's views on the size of the surplus (ie a cash surplus of $2.8billion[38]) in the recent federal budget.[39]

2.42 The Bank noted that, traditionally, central banks have been expected to criticise fiscal policy. However, the Bank reported that '… the current stance of fiscal policy is not making the Reserve Bank's job any harder, so we have no desire for a different fiscal policy …'[40] It said this is the fourth year in a row of surplus, there is no borrowing and the outstanding stock of government debt to GDP is lower in Australia than in any developed country. There is going to be a fiscal stimulus due to the tax reform package but it will be at a time where the Bank believes private demand is slowing. The Bank believes that the net outcome of all these things is going to give a growth rate which is pretty reasonable. It said '… We do not see any reason why that is causing us to do something with interest rates that we do not want to do.'[41]

2.43 In fact the Governor reported that 'I think internationally we are regarded as having a very good fiscal policy. We are probably regarded as having a fiscal policy which is almost second to none. …'[42]

2.44 The Committee’s observation is that the internationalisation of the economy has meant that markets now have less tolerance of budget deficits. As a result, governments now have a narrower range of options on fiscal policy.

2.45 The result is that the Reserve Bank is being moved closer to centre stage on economic management.

Economic growth

2.46 In his opening statement, the Governor noted that Australia’s growth in the 1990s exceeded anything achieved in the 1970s and 80s. It has run for longer and with less quarterly variation than the growth cycles in either of

38 *Budget speech 2000-01.* Delivered on 9 May 2000 by the Honourable Peter Costello MP, Treasurer of the Commonwealth of Australia, p 1.

39 Evidence pp 72-3.

40 Evidence p 65.

41 Evidence p 66.

42 Evidence p 73.

those earlier decades. In the 1990s, only Ireland among the developed countries, has grown faster than Australia.[43]

2.47 During the Asian Crisis, with exports to Asia struggling, the engine of growth was consumer demand. Now the indications are that those positions are reversing, as exports are growing rapidly and consumer demand is starting to weaken.

2.48 When asked about the likely trends in the economy, the Bank's summation was: that the growth in exports will remove a negative effect from last year's GDP result and this will be supplemented by the fiscal stimulus. These trends are expected to increase GDP by about ¾%, compared to last year. The Bank expects these two factors to counterbalance the expected decline in consumption growth, even if it proves to be quite a substantial one.[44]

2.49 In his opening statement, the Governor said that while a repeat of the 4½% growth rate of recent years was not expected, the economy should grow at quite a solid rate in the year ahead. He said that he had little quarrel with the rate of 3¾% predicted in the Budget papers. When questioned about that prediction, he described it as a "pretty realistic figure".[45]

2.50 In answer to a question on the prospects for investment, the Assistant Governor (Economic) said that investment growth has three main components. Of these, investment in non-dwelling construction is falling and is likely to continue to do so. The second and biggest component, investment in equipment, seems to have bottomed out and the expectation is that it will increase during the coming year. The third component, mainly computer software, has been growing at 20% per year and this trend should continue. Overall, investment is expected to grow a little faster over the next year to eighteen months.[46] He commented:

> … we have already had a pause in investment, and most of the forward looking indicators suggest that that pause is coming to an end and investment may be picking up again.[47]

2.51 The strength of the economy has shown itself in the growth of real wages. The Governor remarked that in a strong economy with low inflation, real wages should continue to grow "and, by and large, they have". He continued:

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43 Evidence p 47.

44 Evidence p 55.

45 Evidence pp 46 and 75.

46 Evidence pp 55-6.

47 Evidence p 51.

> It seems to me that the best way to get real wage increases is to have long, strong expansions with low inflation, and that is what we have been having.[48]

2.52 The Committee observed that the reforms of the last few years seem to have allowed the Australian economy to sustain a higher rate of growth without inflation getting out of hand. The Bank agreed and said that goods and labour markets were now more competitive.[49] In his opening comments, the Governor also referred to the greater efficiency of the economy, when he said:

> We have to allow for structural change, such as the increased competitive pressure in goods markets. This has been an important ingredient in maintaining downward pressure on many prices and should be helpful in negotiating the introduction of the GST.[50]

2.53 The Bank commented also that the long period of low inflation has contributed to this situation by conditioning people to accept low inflation as a normal condition – not likely to disappear quickly.[51]

Relationship between the Australian and US economies

2.54 Discussion continued at this hearing on the relationship between the Australian and US economies.

2.55 The Bank noted the degree of similarity at present between the Australian and US headline inflation rates (2.8 in Australia and about 3 in the US) and the same underlying inflation at 2.25%. However, in looking ahead it pointed out that there are differences due to greater inflationary pressures in the US and the added complication of extremely inflated asset prices in the US. As a result this is putting pressure on the US to raise interest rates and the pressure to do this in the US is greater than in other countries. The Bank noted that the US has been reluctant to tighten interest rates simply to bring down asset prices - rather, they have waited to see old fashioned measures like wages picking up before they act decisively (for example the recent 50 basis points rise in rates).[52] In its Semi-Annual Statement the Bank noted that '…Much will depend on the success of US monetary policy in reining back the economy in a timely manner, and this

48 Evidence p 57.
49 Evidence p 71.
50 Evidence p 48.
51 Evidence p 71.
52 Evidence p 75.

will depend in part on a return to more subdued sentiment in the equity markets…'[53] It confirmed this statement at the hearing and said a number of other countries too are hoping that the US gets its adjustments implemented quickly.[54]

2.56 The Bank also commented on the current similarities and past differences between the Australian and US 10-year bond yields. It noted that their current similarities in no way mean that Australia has lost its monetary independence.[55]

2.57 The Governor noted that the Chairman of the US Fed is under the same pressures domestically as the Reserve Bank not to raise interest rates. It is also subject to similar criticisms to the Reserve Bank if it does.[56]

Effects of the new tax system

2.58 The imminent introduction of the New Tax System, incorporating the GST, has prompted close examination of predicted levels of inflation, particularly for the next two years. The Committee asked whether the Bank was still expecting the inflationary effect of the GST to be temporary and that there will not be a round of wage claims to compensate for the GST – the assessment given by the Bank at the last hearing in November 1999.[57]

2.59 The Governor said that the Bank was still operating on the assumption that wage-earners would not seek double compensation for the GST. In answer to a further question, he added:

> … In other words, we are working on the assumption that the income tax changes more than compensate for the GST and that wages will not expect another compensation through the wage bargaining process.[58]

2.60 The Committee recalled that the Semi Annual Statement had mentioned the possibility of increased pressure on wages, fuelled by an increased expectation of inflation in the economy. It queried how the Bank could, in that Statement: warn of a material risk of wages pressure; repeatedly refer

53 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000.* RBA, Sydney, p 1.

54 Evidence p 75.

55 Evidence p 77.

56 Evidence p 75.

57 Evidence pp 5 and 53.

58 Evidence p 53.

to the fact that second round wage negotiations and inflationary impacts were already occurring; comment on the risk of a significant acceleration in wages produced by increased inflationary expectations; and then follow its assessment of the inflation outlook with the comment:

> … The assumptions underlying this projection include no second-round effects of the GST on wages and prices, …[59]

2.61 In reply to these questions, the Bank drew a clear distinction between wage claims which are presently in progress – and referred to in the Statement – and those which might be sparked by the GST. The forecasts related to the latter situation, not to claims already being pursued. The Committee pointed out that if the likelihood of compensatory wage claims is sufficient for it to be mentioned several times in the Semi Annual Statement, then it cannot simply be assumed away in forecasts.[60]

2.62 The Governor responded that current wage claims had been factored into the Bank's assessment of inflation – and had contributed to the conclusion that domestic sources of inflation are now higher than before. Overall, however, the indications are still very subdued and have not yet shown up in the statistical series on earnings. Consequently, there is little hard evidence of a substantial change.[61]

2.63 The Bank acknowledges that inflationary expectations for the next year are higher because of the GST but that does not mean an increase in the rate of underlying inflation. The Governor said:

> We are not saying that the GST will lead to higher inflation; we are saying that it will lead to a lift in the price level and that that has got into this particular measure of inflationary expectations.[62]

2.64 When asked about his assertion at the November 1999 hearing, that wage claims seeking compensation for GST effects could be avoided, the Governor said he could only repeat what he had said at that time. He said that the Bank's view of the GST effects remained the same.[63] Later he added:

> I would be very disappointed if there were generalised wage pressure for what I would call double compensation. As I said, we are assuming that it is not going to happen or that it is going to happen on a negligible scale.[64]

59 Evidence pp 53-5.
60 Evidence pp 54-5.
61 Evidence p 55.
62 Evidence p 84.
63 Evidence p 55.
64 Evidence p 57.

2.65 The Committee, however, notes that enterprise bargaining frequently includes provision for review, in the event of increases in the CPI.

2.66 This issue will be pursued again at the next hearing, as the Committee questions the adequacy of the Bank's response. It believes that the response of wages to the introduction of the New Tax System will be a critical factor in monetary policy.

2.67 The question of the Bank's ability, after 1 July, to distinguish between the effects of the GST and the underlying inflationary influences was raised by the Committee. The Bank is expecting that there will be difficulties in reaching precise figures, especially in the September quarter. After that, the distinction should become clearer. Most of the GST impact will be in that first quarter.[65]

2.68 When asked whether any of the increased inflationary pressure we are seeing now could be caused by anticipation of the GST, the Governor responded that this seemed to be occurring in the housing industry but not in other sectors. The housing sector is running at full capacity in anticipation of 1 July and there could be some inflationary effect from that.[66]

Independence of the RBA

2.69 Commentary in the *May 2000 Semi-Annual Statement on Monetary Policy* that some 'political comments on interest rates' had encouraged a view that Australia was unlikely to match US interest rate rises fuelled a public debate concerning the independence of the Reserve Bank and the appropriateness of Government comments on interest rate policy.[67]

2.70 Some media commentators said that the Government was not attempting to influence the Reserve Bank in its deliberations on interest rates. Rather, its efforts were really directed at the electorate. Some Committee members did not believe this was the case. Concerning this issue, the Statement on the Conduct of Monetary Policy (Appendix G), which set out the common understanding of the Governor of the Bank and the Government, said:

65 Evidence p 84.

66 Evidence p 85.

67 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, p 38.

> Consistent with its responsibilities for monetary policy as a whole the Government reserves the right to comment on monetary policy from time to time. …[68]

2.71 In response to a question at the hearing about the potential for the government to influence the Reserve Bank Board, the Governor responded:

> …I can give you complete assurance that there has been no pressure on the Reserve Bank Board from any part of the government to get us to do anything other than what we would normally wish to do.[69]

2.72 Regarding the Government's comments, based on the 1996 agreement between the Government and the Reserve Bank,[70] it is appropriate and legitimate for the Government to express a view. During extended discussion on this issue, the Governor pointed out on a number of occasions that there was nothing improper in the Government commenting on monetary policy, indicating that logically, such comment could only occur in an environment in which the central bank was independent[71]:

> … I think one of the reasons for this attracting a lot of attention is that it can happen only when you have an independent central bank. It cannot happen if the government is making monetary policy; it cannot get up and criticise itself and give alternative views. It seems to me that it is just an inevitable result of having an independent central bank in a democratic society.[72]

2.73 Government comments on interest rates have been linked to an apparent difference of opinion between the Secretary of the Department of the Treasury and the Reserve Bank over the appropriate interest rate response to the weakness of the dollar over the past four months. This apparent difference of opinion also raised the issue of the presence on the Board of the Secretary of the Department of the Treasury. When questioned by the Committee at the hearing, the Governor indicated that:

> You are starting to open a great issue of the Reserve Bank Act, the structure of the Reserve Bank Board and the Reserve Bank

68 *Statement on the Conduct of Monetary Policy*, Reprinted in Reserve Bank of Australia, Report and Financial Statements 30 June 1997, RBA, Sydney, p 9; see also Appendix G.

69 Evidence p 60.

70 Reserve Bank of Australia. *Report and Financial Statements, 30 June 199*7. RBA, Sydney, pp 8-10.

71 Evidence pp 59-61.

72 Evidence p 59.

> mandate, which I do not particularly want. I am comfortable with the current arrangements we have.[73]

2.74 There was some discussion of whether Australia was the only country in the OECD in which an official of the Department of the Treasury sat on a policy making central bank board. The Committee would like a response to this question at the next hearing.[74]

Transparency

2.75 Since the last hearing with the Bank, some public comment has addressed the issue of the transparency of the Board's decision making processes.

2.76 At the hearing, while conceding that access to the minutes provides some advantages, the Governor gave two reasons why the release of board meeting minutes would not be valuable:

- the minutes come out at the very earliest some weeks after the decision; and
- the people drafting the minutes have the advantage of hindsight in terms of the emphasis of the minutes.[75]

2.77 The Governor argued instead that the current situation, in which a media release is produced to coincide with board decisions, provides, in international terms, a strong measure of transparency for board decision making:

> … Where we stand in the international spectrum is that we have the most detailed account of anyone, at the time immediately the change is made … We are the only ones that make a serious attempt ...[76]

2.78 Given the importance of the Reserve Bank's decisions and their effect on economic management of the economy, the Committee will continue to review this issue. Clearly, the twice yearly public appearances by the Bank continue to be a major part of the transparency of its decision making and an important part of its accountability to Parliament.

73 Evidence p 78.
74 Evidence p 78.
75 Evidence p 81.
76 Evidence p 81.

3

Other matters

Payments system

3.1 The recent release of the Cruikshank report into Competition in UK Banking[1] prompted the Committee to again question the Bank on the efficiency of the credit card payment system in Australia. The Cruikshank report found that competition between debit and credit payments systems was not sufficient, generating: interchange fees that were set at levels that do not reflect the actual cost of transactions; cross subsidisation of the expensive credit card payment system; and rises in costs to consumers.[2]

3.2 The Payments System Board is currently undertaking an examination of interchange fees.[3] Interchange fees are the fees paid by banks to each other to cover the cost of administering credit card transactions.[4] By some estimates, these fees are worth $600 million a year.[5]

3.3 The Governor said that the additional powers of the Payments System Board to regulate and obtain information on payment systems would mean it had an easier task in obtaining information than the Cruikshank committee. That committee was handicapped by the reluctance of the credit card cooperatives to provide information on interchange fees.[6] The Governor hoped the investigation into interchange fees would be

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1 *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, HM Treasury, London, 2000, p 339.

2 *Competition in UK Banking: A Report to the Chancellor of the Exchequer*. HM Treasury, London, 2000. pp 269-271.

3 Evidence pp 79-80.

4 Evidence p 80.

5 *Credit Card System Ready For Change*. Mair, P. *Australian Financial Review*, 16 May 2000.

6 Evidence pp 79-80.

completed before the Bank appeared before the Committee in November/ December 2000.[7]

3.4 The efficiency of another aspect of the credit card payment system, merchant fees, which cover the cost of providing credit and debit facilities to merchants,[8] will be the likely next point of investigation for the Payments System Board. Merchant fees are estimated to be worth $935 million a year in Australia.[9]

3.5 At the last hearing with the Committee the Bank indicated that a number of banks, including two of the major banks, were not providing three day cheque clearing times.[10] At this hearing, the Governor reported that these financial institutions were still not guaranteeing a three day clearance time. He indicated that more details on cheque clearance times would be included in the Payments System Board annual report, due out later in the year.[11]

3.6 The Committee registered the view that this is unsatisfactory and urged the RBA to push the banks to hasten to meet this target. It will review the issue in its consideration of the PSB annual report.

3.7 The RBA and the ACCC are conducting a joint study on interchange fees for debit and credit cards. A draft paper for public comment is expected to be released at the end of July or early in August.

3.8 In a related matter, the ACCC is reviewing the trade practices involved in uniform pricing agreements among the major credit card providers. The Commission has recently written to the banks to indicate that it believes they are engaged in unlawful price fixing in setting credit card interchange fees. The Commission has requested that the banks either seek ACCC authorisation for the fees or cease that conduct. If the banks do not comply, the Commission may institute proceedings against them.[12]

3.9 The Committee may pursue this matter further in the light of the findings.

7 Evidence p 80.

8 Evidence p 80.

9 Evidence p 80.

10 Official Committee Hansard, House of Representatives Standing Committee on Economics, Finance and Public Administration. Reference: Reserve Bank of Australia annual report 1998-99, Sydney, 29 November 1999, p 44.

11 Evidence p 90.

12 *Banks Face Price-Fixing Fines.* Murphy, K. et al. *Australian Financial Review*, 31 May 2000.

Bank fees

3.10 The Reserve Bank's submission on bank fees in Australia (Appendix H) updates and expands the information on bank fees contained in the *Reserve Bank of Australia Bulletin* of June 1999 and on small business bank fees contained in a submission made to the Committee prior to the November 1999 hearing.[13] The new submission, contains bank fee information from 1997 to 1999 for the 6 largest banks and 10 additional banks, which together account for 90% of all bank assets in Australia.[14] As the statistics in this submission cover more banks than the information produced by the Bank in 1999, the studies are not directly comparable.

3.11 The main features of the Bank's assessment indicate that:

- fees to households are rising faster than fees to business;
- revenue from housing loan fees has fallen but fees on other personal loans have risen quickly; and
- revenue from business loan fees has risen faster for large borrowers than small borrowers.

3.12 The submission indicates that banks' pricing practices have not changed significantly since the tabling of the Committee's Interim Report.[15] Banks are continuing to recoup the cost of providing payment services directly through fees rather than doing so indirectly through interest rate margins. Nonetheless, falling interest margins have not been offset by increases in fees, generally providing a benefit to housing borrowers and small business.[16] According to the Deputy Governor, Dr Stephen Grenville:

> The really powerful point to make is that … the rise in fees has been relatively small compared with the fall in margins ...[17]

3.13 The Committee noted, however, that customers without a loan, those with small balances and high levels of transactions will not have benefited from these pricing trends.[18] This fact is of considerable concern to the Committee.

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13 *Bank Fees In Australia,* Reserve Bank of Australia. *Bulletin,* June 1999. JS MacMillan, Sydney, pp 1-10; and Reserve Bank of Australia, Submission No.1, 25 November 1999.

14 Reserve Bank of Australia, Submission No.1, 25 November 1999, p 1.

15 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of the Reserve Bank of Australia Annual Report 1998-99: Interim report,* March 2000, Canberra, CanPrint Communications Pty Ltd, pp 37-9.

16 Reserve Bank of Australia, Submission No.1, 25 November 1999, p 8.

17 Evidence p 87.

18 Reserve Bank of Australia, Submission No.1, 25 November 1999, p 8.

Outsourcing

3.14 Under the new devolved banking arrangements, government departments and agencies are, within a reasonable time, required to test the services provided by the Reserve Bank against what is available from other service providers.[19] To date, in addition to the Department of Finance and Administration (DoFA), some smaller government agencies have taken their banking services to tender,[20] but the Bank said:

> The main outsourcing or the main loss of function of the Reserve Bank is actually coming from state governments who have taken their business away from us ...[21]

3.15 The outsourcing of State and Territory government banking functions has resulted in the closure of Reserve Bank regional offices in most State and Territory capitals, with the exception of South Australia and the ACT. The Bank retains its head office in Sydney. The Committee will continue to monitor progress on this matter.

3.16 In response to a question on the impact on staff of forthcoming amendments to the Reserve Bank Act, the Governor replied that he did not think there would be any impact at all. He commented that “it is just a matter of simplifying the legislation.”[22]

Margin lending

3.17 In the opinion of the Deputy Governor, Dr Grenville:

> … although margin lending in Australia has risen quickly from $2 billion to $6½ billion in just three years, in absolute terms it is quite small and is therefore not a threat to system wide stability.[23]

3.18 He commented that in Australia margin lending amounted to about 1% of GDP, while in the US it was 2% of GDP. He noted also that in 1929, it was 22% in the US.

19 Reserve Bank of Australia. *Report and Financial Statements*, 3 August 1999, RBA, Sydney, pp 44-45.

20 Evidence p 89.

21 Evidence p 89.

22 Evidence pp 93-4.

23 Evidence p 86.

3.19 The Bank was also unconcerned about margin lending because margin borrowers were borrowing amounts like 50% of the borrower's own capital, which is considered a safe margin.[24]

Common currency

3.20 Recently, the Institute of Policy Studies at the Victoria University in Wellington, New Zealand published a study that concludes that there is a prima facie case for genuine consideration of a shift away from the New Zealand dollar towards the adoption of a currency based either on the Australian dollar or the US dollar.[25]

3.21 When asked to comment on this possibility, the Bank indicated that they had not formed a view on this subject:

> We take a pretty low key role in this because it is mainly of concern to the smaller of the two countries. The smaller of the two countries is going to get the benefits or pay the costs. The smaller of the two countries will have worry to about the loss of sovereignty...[26]

The Y2K experience

3.22 For the record the RBA reported on lessons learnt from the Y2K experience. The Governor noted that although '…nothing bad happened…'[27] the Bank did not consider that it had over-insured against the risk nor that the exercise was too costly. Costs were related to staff costs, overtime worked and a higher stock of bank notes that will now need to be run down over time. The RBA said it will provide a more detailed account of the costs of its Y2K experience in its forthcoming annual report. The Committee will review this issue further when the annual report is released.

David Hawker MP
Chairman
19 June 2000

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24 Evidence p 86.

25 *An ANZAC Dollar? Currency Union and Business Development*, The Institute of Policy Studies, May 2000.

26 Evidence p 80.

27 Evidence p 91

Minority Report—Mr Anthony Albanese MP, Ms Anna Burke MP and Mr Mark Latham MP (ALP)

INDEPENDENCE OF THE RBA

In the weeks leading up to the RBA hearing there was an extraordinary exchange of views between the Government and members of the Reserve Bank Board. The Prime Minister, Treasurer and Secretary to the Treasury mounted public arguments against any further increase in interest rates. The Government also undertook background briefing against the credibility of the RBA, leading a number of commentators to describe the Government as "at war" with the Bank.

This followed media speculation that the Secretary to the Treasury, in his role as a RBA Board member, had been voted down on several interest rate decisions. Significantly, the Governor refused to answer Committee questions on "whether recent (Board) decisions have been unanimous"[1].

At the Committee hearing the Governor went out of his way to avoid any further controversy with the Government. This concerned four issues:

- the Governor's insistence that the introduction of the GST package was not a factor in the conduct of monetary policy, even though the GST was having an adverse impact on inflationary risks, inflationary

1 Evidence p 73.

expectations, second-round wage impacts, plus "overheating in a few markets"[2].

- the Governor's view that the recent deterioration in the Federal Budget surplus was "not making the Reserve Bank's job any harder, so we have no desire for a different fiscal policy "[3]; even though in November 1999 he told the Committee that:

> … given we are in the ninth year of an expansion and we had big deficits in the early years, shouldn't you be counterbalancing this with big surpluses in the latter years of an expansion? The answer is yes, in principle I think you should.[4]

- the Governor's refusal to answer questions concerning the observation in the Semi-Annual Statement that "some political comments about interest rates" triggered a depreciation in the Australian dollar in late January. He dismissed this as "a media event, not an economic event"[5].
- the Governor's claim that the RBA is independent of the Government, even though the Government's chief economic official (the Secretary to the Treasury) sits on the RBA Board.[6]

In each of these instances, the credibility of the Reserve Bank has been diminished. Particularly on the question of fiscal policy, it is unacceptable for the RBA to point to political considerations when the Bank itself is supposed to be independent of the political process.[7] Moreover, it is unacceptable for the RBA to refuse to answer questions on material published in its Semi-Annual Statement. This is a failing in the Bank's accountability to the Parliament.

In his opening statement to the Committee, the Governor said that, "the decisions to raise interest rates were relatively straight forward ones. The situation is not as straight forward now. Signs of a near-term acceleration in growth have gone. As discussed earlier, there are now signs of slowing domestic demand."[8]

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2 Evidence pp 53, 83-4 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 2000*. RBA, Sydney, pp 46-9.

3 Evidence p 65.

4 Evidence p 21.

5 Evidence pp 58-9.

6 Evidence p 78.

7 Evidence p 72.

8 Evidence p 48.

This was interpreted by the financial markets and subsequently confirmed by the Governor as a sign that interest rates are on hold. Since then, however, the March Quarter National Accounts have shown continuing strong economic growth and consumer spending. Most indicators now point to upward pressure on interest rates: strong world growth, rising US interest rates, a weak Australian dollar, the Olympics boom, rising asset prices, strong credit growth, GST-related risks, a strong fiscal stimulus after 1 July and the deterioration in the Federal budget.

Unfortunately the RBA has got itself caught between these economic fundamentals and political pressures from the Federal Government. This is not a good way to conduct monetary policy. The Governor should have been stronger in putting the Prime Minister and the Treasurer back in their box.

These matters raise the issue of the structural independence of the RBA. Mr Macfarlane argued that criticism of the RBA by the Government in fact demonstrated the Bank's independence. This assertion is incorrect on two fronts:

- whenever the Government publicly criticises the RBA over interest rate policy it is reasonable to assume that this view will be reflected in the participation and voting of the Government's chief economic official on the RBA Board.
- if public criticism is proof of one's independence, it is interesting to note that the Governor himself has failed this test over the past four years. Unlike his predecessor, he has not made a single public comment on the ways in which Government policy might be improved. This is despite the Committee's attempts to engage him on issues such as national savings, labour market policy, taxation and fiscal policy.

The Committee's report notes the growing importance of the conduct of monetary policy. In the past, some commentators have suggested that the RBA requires full-time Board members, rather than a series of part-time appointments, mainly from a business background. This change would recognise the enhanced role of the RBA in Australian economic policy making. Moreover, business representatives face the possibility of conflicts of interest between interest rate policy and commercial considerations. In the reform of the RBA Board, this is an important matter to address.

Some Committee members have also expressed concern about the independence and transparency of the RBA Board. It is difficult to see how the RBA can avoid this criticism as long as the Government's chief economic official sits on its Board. The recent controversy has again highlighted this problem. Committee members have also pursued the need for the RBA to publish the minutes of its Board meetings, thereby matching comparable international practice and improving the transparency of its decision making.

Accordingly, the Committee should commission research work and examine the following proposals:

1. That the RBA Board be made fully independent of the Federal Government by removing the Secretary of the Treasury.
2. That one of the full-time members demonstrate particular expertise in regional and labour market policy. (This measure would address public concerns about the impact of monetary policy on regional development.)
3. That the RBA publish its Board minutes at a suitable period of time after each meeting.
4. That the arrangements specified in the 1996 exchange of letters between the RBA and the Government be converted into legislation. (These arrangements for the independence, transparency and accountability of the Bank would have a stronger standing at law, plus greater credibility in the eyes of financial markets, if they were included in the RBA statute.)

Anthony Albanese MP　　Anna Burke MP　　Mark Latham MP

A

Appendix A - List of Submissions

Submission No.	Individual/Organisation
1	Reserve Bank of Australia: *Notes on Bank fees to Small Business*, 25 November 1999.
2	Reserve Bank of Australia: *Notes on Bank fees in Australia*, 18 May 2000 (See Appendix H).

B

Appendix B - List of Hearings, Briefings and Witnesses

Public Hearings

Monday, 22 May 2000 - Melbourne

Reserve Bank of Australia

Dr Stephen Grenville, Deputy Governor

Mr Ian Macfarlane, Governor

Mr Glenn Stevens, Assistant Governor (Economic)

Monday, 29 November 1999 – Sydney

Reserve Bank of Australia

Dr John Laker, Assistant Governor (Financial System)

Mr Ian Macfarlane, Governor

Mr Glenn Stevens, Assistant Governor (Economic)

Private Briefings

Thursday, 11 May 2000 - Canberra

Mr Barry Hughes, Chief Economist, CS First Boston

Mr Peter Osborne, Chief Economist and First Vice President, Merrill Lynch Australia

Monday, 22 November 1999 – Canberra

Mr Peter Osborne, Chief Economist and First Vice President, Merrill Lynch Australia

Professor Tom Valentine, School of Economics and Finance, University of Western Sydney

Thursday, 30 September 1999 – Canberra

Mr Peter Mair, Visiting Lecturer on the Australian Financial System, University of Wollongong

C

Appendix C - RBA Media Release on Monetary Policy dated 3 November 1999

RESERVE BANK OF AUSTRALIA

MEDIA RELEASE **No:** 1999-11

Date: 3 November 1999 **Embargo:** For Immediate Release

STATEMENT BY THE GOVERNOR, MR IAN MACFARLANE

MONETARY POLICY

Following a decision by the Board at yesterday's meeting, the Bank will be acting in the money market this morning to increase the cash rate by 25 basis points, to 5.0 per cent.

The international economic environment has improved considerably since last December, when the previous adjustment to monetary policy was made. At that time, world growth was expected to be weak, global inflation was tending to fall and international interest rates were declining. The likelihood of some decline in Australia's growth and the continuing very low inflation allowed scope for monetary policy to move in the expansionary direction. As things have turned out, global growth this year has been a good deal stronger than expected, and a further strengthening appears likely in 2000. Most of Australia's Asian trading partners are in recovery, and global disinflationary forces have abated. The Australian economy is growing faster than the Bank or most other forecasters had expected.

At the same time, inflation has now returned to the 2-3 per cent target zone, after a lengthy period of being below target. The CPI increased by 1.7 per cent over the year to the September quarter. This figure was held down by the effects of the health care rebate; abstracting from this, the CPI increase was a little over 2 per cent over the year. Some of the increase in inflation has come from higher oil prices, but core or underlying measures of inflation, which exclude oil prices, have also run at about 2 per cent over the past year. Some further gradual increase in inflation is likely over the next two or three quarters.

The stance of monetary policy has been expansionary over the past couple of years. Interest rates in real and nominal terms for virtually all borrowers have been below the low points reached in the early 1990s, and credit growth has been strong. This was the appropriate setting of policy through the period when the forces affecting the economy from abroad were contractionary. The need for such an expansionary setting has now passed, and accordingly, the Board has decided to increase cash rates modestly, so as to take policy to a less expansionary setting.

This adjustment will not bring to an end the current expansion, now in its ninth year, nor is it designed to do so. On the contrary, it is designed to keep the setting of policy attuned to the economy's changing needs, so as to maintain inflation of 2-3 per cent over the medium term. This will prolong the expansion, and a long, steady expansion offers the best chance to achieve further progress in reducing unemployment.

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D

Appendix D - RBA Media Release on Monetary Policy dated 2 February 2000

RESERVE BANK OF AUSTRALIA

MEDIA RELEASE **No:** 1999-11

Date: 3 November 1999 **Embargo:** For Immediate Release

STATEMENT BY THE GOVERNOR, MR IAN MACFARLANE

MONETARY POLICY

Following a decision by the Board at yesterday's meeting, the Bank will be acting in the money market this morning to increase the cash rate by 50 basis points, to 5.5 per cent.

In the three months since the Bank last made an adjustment to interest rates, the international economic environment has strengthened further, with world growth outcomes in 1999 ahead of most expectations, and forecasts for 2000 being revised up again. Inflation rates have also increased, principally due to higher oil prices. In most countries, central banks have continued a process of gradually increasing short-term interest rates from unusually low levels reached a year ago.

The Australian economy, likewise, has continued to record stronger growth than had been expected. Household spending in particular has remained exceptionally robust, supported by income gains flowing from the strong employment growth, with the high level of vacancies indicating this is likely to continue. Spending has also been boosted by substantial gains in wealth, much of it coming from buoyant housing prices. With credit inexpensive and freely available, households have availed themselves of the opportunity to borrow so that credit to this sector has grown by over 15 per cent in the most recent twelve months, and more quickly in the second half of the period. Business surveys suggest that, despite some differences across sectors, conditions overall are very favourable. Indicators of capacity utilisation are approaching previous cyclical highs, and respondents to surveys are starting to report increasing difficulty in finding suitable staff.

At the same time, the unusually low inflation rates of 1997 and 1998 have now passed. Although the recent CPI was lower than expected, inflation as measured by the CPI is rising, and likely to be in the upper half of the 2 to 3 per cent target zone by mid year. Some of the increase is due to the direct effects of higher international oil prices, but measures of core or underlying inflation, which are not distorted by such impacts, are presently running between 2.1 and 2.4 per cent. Wages growth has to date remained moderate, but some recent developments point to higher wage demands in the future.

During the period ahead, growth is likely to remain strong, particularly given the improved environment for exports. While future growth rates will no doubt be subject to the normal quarterly variation, a significant slowdown is unlikely - previous expectations of a slowdown have persistently proved unfounded, even when there were stronger reasons than there are now to expect one. It is more likely that with growth and confidence high, and with the economy in the ninth year of its expansion, inflationary pressures will tend to build up as the year progresses. In these circumstances the Bank considers that it would be unwise to continue with the expansionary monetary policy setting which has been in place until now.

Financial markets have for some time been expecting an increase in interest rates, and speculating about the possible size of the move on this occasion. In the Bank's view, a rise of half a percentage point makes sense, both in light of the economic outlook, and of the opportunity it gives to signal that monetary policy has been moved to a neutral stance, given the current economic outlook.

This tightening, like its predecessor in November, can be viewed as pre-emptive in that it has occurred before overheating has emerged, and its aim is to prevent that eventuality from occurring. It will not bring the expansion to an end, but is intended to avoid the build-up in the sort of imbalances which in the past have been responsible for that result. Prolonging the expansion is the major contribution that monetary policy can make to further reducing unemployment and raising living standards.

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E

Appendix E – RBA Media Release on Monetary Policy dated 5 April 2000

RESERVE BANK OF AUSTRALIA

MEDIA RELEASE **No:** 2000-08

Date: 5 April 2000 **Embargo:** For Immediate Release

STATEMENT BY THE GOVERNOR, MR IAN MACFARLANE

MONETARY POLICY

Following a decision by the Board at its meeting yesterday, the Bank will be operating in the money market this morning to raise the cash rate by 25 basis points, to 5.75 per cent.

The fundamental reason why interest rates have risen in Australia and in most other developed countries over the past year is that the degree of monetary stimulus that was appropriate to earlier circumstances is no longer needed.

In Australia's case the trend of economic activity has been strong in recent years, even during a period in which the external environment was distinctly unfavourable, and which on all past experience would have been expected to lead to a marked decline in growth. Several forces were at work in producing this very favourable outcome. One of them, in the Bank's judgment, was a relatively easy monetary stance. That monetary policy has been expansionary is quite clear from the rate of growth of borrowing, the level of interest rates in real and nominal terms, and developments in asset markets. This type of policy stance was appropriate when the external influences were contractionary and where inflation had fallen below the 2-3 per cent medium-term objective for policy.

It was never likely, however, that such low interest rates could persist indefinitely: as an economy's circumstances change, so does the level of interest rates which is appropriate. While there is no evidence of widespread overheating in the Australian economy, some areas point to incipient pressures. Credit, especially to households, is growing quickly, and speculative activity in asset markets has increased, although to nowhere near the same

extent as in the late 1980s. In some areas skill shortages have emerged. Pressure for higher wage rises appears to be building, even though wages growth to date has been restrained.

When the March quarter CPI becomes available later this month, it is likely to show CPI inflation running above 2½ per cent, and it could be higher by mid-year. Some of this pick-up is driven by oil prices, just as the very low inflation figures of a year or two ago were driven in part by falling oil prices. But the tendency for somewhat higher inflation is also clear from the range of core inflation measures.

The recent behaviour of the exchange rate also points to the need for some monetary adjustment. Until recently, purely domestic medium-term considerations were the major reason behind monetary policy moves, and relativities with the rest of the world played only a minor part. With the fall in the exchange rate over the past two months, however, international financial developments have assumed a more important role. The fall has occurred in the face of a strengthening world economy, which ordinarily would be expected to put upward pressure on the currency. The Bank's reading of this development is that it reflects an assessment by market participants that monetary policy settings in Australia have been, and could continue to be, more accommodating relative to other countries than is justified by our relative economic performance. This is in marked contrast to the exchange rate's fall in 1998 which was driven by a real factor genuinely beyond Australia's control, namely the contraction in our export markets.

The level of the exchange rate is not an end in itself, but is important insofar as it can affect future inflation, an important consideration under an inflation targeting framework. As it turned out, the fall in the exchange rate in 1998 had little discernible effect on inflation because it occurred at a time of pronounced disinflationary, or even in some cases deflationary, pressure in markets for internationally traded goods and services. On this occasion, however, the global and domestic environments are different. Disinflationary forces abroad are likely to be waning, and domestic inflation already is noticeably higher than it was in 1998. Hence a weak exchange rate cannot be assumed to be so benign.

With the world economy growing strongly, and forecast to remain buoyant, the Bank's judgment is that the Australian economy should continue to experience good growth. Growth in domestic demand is coming back to a more sustainable pace from the high rates of last year, but exports are picking up. Trends in employment and vacancies suggest that the labour market is buoyant, and credit growth to households and business is strong. While some slowing in consumption was expected, the recent fall in retail trade was a surprise. Nevertheless, the Bank's judgment is that when looking at the economy as a whole, the picture is one of strength rather than weakness.

But the decision to increase rates is motivated not so much by a particular view of the short-term strength of economic activity as by the gradual shift in the balance of risks to the medium-term outlook which has occurred over the past year. This balance now tilts more in the direction of inflation concerns, and less in the direction of concerns over the economy's growth prospects, than it did.

As the Bank has stated on numerous occasions, the ultimate goal of macroeconomic policies is to maximise the length of the expansion. The measures the Bank has been taking over recent months are designed to achieve that outcome.

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F

Appendix F - RBA - Media Release on Monetary Policy dated 3 May 2000

RESERVE BANK OF AUSTRALIA

MEDIA RELEASE **No:** 2000-11

Date: 3 May 2000 **Embargo:** For Immediate Release

STATEMENT BY THE GOVERNOR, MR IAN MACFARLANE

MONETARY POLICY

Following a decision made by the Board at its meeting yesterday, the Bank will be raising the cash rate target by 25 basis points, to 6 per cent, effective immediately.

At its meeting, the Board again considered the range of domestic and international factors relevant to monetary policy. Domestically:

- While some indicators of domestic demand suggest that growth rates have moderated from the very high rates in the second half of 1999, the Australian economy is benefiting from stronger exports and rising terms of trade.
- On the latest available data, the demand for credit, if anything, has strengthened so far in 2000. Credit growth over the year to March of 11-12 per cent, and over 16 per cent for households, remains above that which can be sustained in the long run. Gains in household wealth have been large, related mainly to the strong rise in dwelling prices. Readily-available, low-cost credit accommodated this increase.
- Inflation in Australia as measured by the CPI has continued to increase. It rose towards the top of the target zone in March and is

likely to remain there in the short term. The rise in petrol prices has played an important role. Recent trends in the US dollar price of oil suggest that this may now have run its course, with a small decline in petrol prices possible in the next quarter or two, depending on the course of the exchange rate. But a range of underlying measures of inflation, which are not distorted by energy prices and which give a better indication of the trend in consumer prices, show a gradual, but clear, pick-up. These are now about 2¼ per cent, compared with a low of around 1½ per cent late in 1998. Expectations of inflation have also increased. Together with a gradual tightening in the labour market as indicated by survey data, this suggests that some pick-up in wage pressures could easily occur over the coming year or two.

On the international front:

- Global economic conditions are now much stronger than a year ago, and forecasts for global growth have been further upgraded in recent months. Share market developments to date have not caused any significant revision to the economic outlook.
- Inflation and wage costs have picked up in the United States, and in some other countries there has been some rise in underlying inflation.
- World interest rates have continued to increase. The Board noted that most developed countries had now raised interest rates by between 100 and 150 basis points over recent months. While the bulk of this rise reflected a return to more normal levels of interest rates after the unusually low levels of 1998, for some countries exchange rate weakness was also adding to upward pressure on inflation and interest rates.
- The exchange rate of the Australian dollar had fallen further.

In the light of these developments, the Board assessed that the earlier increases in Australian interest rates were appropriate, and that the inflationary risks looking forward warranted a further small increase. In particular, the potential for a weak exchange rate to adversely affect domestic inflation had increased over the past month.

To this extent, as was the case at the time of its decision to raise interest rates in April, the Board was concerned about the increased risks to inflation from international factors. This does not represent any change in the policy framework the Bank has been following for some years now, but a change in the environment in which policy operates. The Board recognised that there is, of course, no certain or mechanical relationship between interest rates and the exchange rate, but it assessed that instability will be reduced by the pursuit of policies which engender confidence among domestic and foreign investors that Australia will remain a low inflation country. Such an outcome is essential to ensuring the longevity of the current expansion.

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G

Appendix G - Statement on the Conduct of Monetary Policy

STATEMENT ON THE CONDUCT OF MONETARY POLICY

THE TREASURER AND THE GOVERNOR (designate) OF THE RESERVE BANK

(Issued on 14 August 1996)

This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor (designate) and the Government to set out clearly their mutual understanding of the operation of monetary policy in Australia.

It is expected that this statement will contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

RELATIONSHIP BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The Reserve Bank Act gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the Reserve Bank Act prescribes procedures for the resolution of policy differences between the Bank and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other industrial countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time. However, the Government will no longer make parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This will enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

OBJECTIVES OF MONETARY POLICY

The framework for the operation of monetary policy is set out in the Reserve Bank Act 1959 which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to the objectives of:

(a) the stability of the currency of Australia;

(b) the maintenance of full employment in Australia; and

(c) the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium term price stability the Reserve Bank has adopted the objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

The Governor (designate) takes this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the Bank's objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

TRANSPARENCY AND ACCOUNTABILITY

Monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly announced and explained. In addition, the Bank has upgraded its public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place the Governor (designate) will support the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank's objectives. It is intended that these statements will include information on the outlook for inflation and will be released at roughly six monthly intervals.

The Governor (designate) has also indicated that he plans to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

The Treasurer expressed support for these arrangements, seeing them as a valuable step forward in enhancing transparency and accountability in the

Reserve Bank's conduct of monetary policy - and therefore the credibility of policy itself.

The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

14 August 1996

H

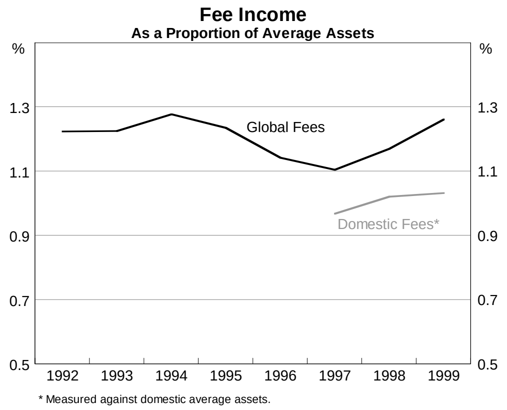
Appendix H - Submission No.2: Notes on Bank Fees in Australia

NOTES ON BANK FEES IN AUSTRALIA*

These notes update, and expand, the information on bank fees in Australia which was published in the in the Reserve Bank *Bulletin* of June 1999.[1] Ten additional banks have been included in the earlier survey of the six largest banks in Australia. The combined assets of the group of 16 banks account for 90 per cent of assets of all banks in Australia. In almost all cases, the additional banks have provided figures for 1997 and 1998 as well as for 1999.

As in the earlier report, the focus in these notes is on fees that banks earn in Australia from households and businesses in the course of taking deposits and making loans, as well as in providing payment services.[2] Such fees earned by these banks increased in aggregate by 13 per cent in 1999 to $5.4 billion, which represented 22 per cent of banks' total income that year. The rise in banks' fees has been a little faster in the past couple of years than the growth in assets, so the ratio of fees to banks' assets has tended to increase. This has been more noticeable in banks' offshore operations than in their domestic operations (Graph 1). Also, fees earned from banks' operations in Australia are lower, relative to assets, than those from their international operations.

Graph 1



Within fee revenue from banks' Australian operations, fee income from loans has increased less quickly than underlying business volumes, while fee income from

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* These notes have been prepared for the information of members of the House of Representatives Standing Committee on Economics, Finance and Public Administration.

1 Supplementary notes on small business fees were prepared for the Committee in November 1999.

2 In addition, banks earn other non-interest income from funds management, trading activities and the like. They also earn non-interest income from their operations in other countries. Non-interest income from major banks' Australian operations accounts for about two-thirds of their total (global) non-interest income.

deposits and transactions has tended to increase by more than this aspect of banks' business. This outcome is generally consistent with published fee schedules of banks which show fees on housing and small businesses loans falling in 1999, while some fees on deposits and on retail transactions have risen.

Households

About a third of fee income, or $1.8 billion, comes from households (Table 1). Loan fees are the main source of fee revenue from households. The rise in revenue from household loan fees in 1999 was somewhat below growth in lending to households. This was because banks discounted establishment fees on housing loans in a highly competitive environment early in 1999.[3] On the other hand, growth in fees from personal loans in 1999 was strong, reflecting both growth in personal lending and rising charges, including on credit cards.

Fee income from deposit accounts has increased substantially faster than household deposit balances. Fees from providing transaction services have become notably more important than they used to be. Part of the growth in revenue from transaction fees reflects growth in the aggregate number of transactions but it also reflects higher charges.

Table 1: Banks' Fees From The Household Sector
$ Million

	1997	1998	1999	Per cent change in 1999
Fees from:				
Deposits	180	215	260	21
Loans				
– Housing	255	430	405	–6
– Other loans	285	270	355	31
Total	540	705	760	8
Transactions	165	330	430	30
Other services	275	305	325	7
Total households	1160	1555	1775	14

3 As housing lending accelerated later in 1999 and into 2000, banks put establishment fees on housing loans back up. This might be expected to show up in their aggregate fee revenue in 2000.

Table 2 shows details of charges for different types of transactions. Fees that banks charge on retail accounts rose across a range of services between 1998 and 1999, although the average account-servicing fee was unchanged (among banks which charge such a fee). Since mid 1999, one of the major banks raised the minimum balance required and the average account-servicing fee has tended to rise, although most transaction fees have been steady. As to the structure of transaction fees, fees on services from low-cost processes, such as internet and telephone payments, tend to be lower than fees from higher-cost processes, like counter withdrawals.

Table 2: Major Banks' Fees On Household Accounts [a]

	1998	1999	Latest
Deposit accounts			
Account servicing ($ per month)[b]	4.00	4.00	5.00
Transaction fees (per transaction)[c]			
Own bank's ATM	0.55	0.60	0.60
Other bank's ATM	1.05	1.30	1.40
EFTPOS	0.45	0.50	0.50
Cheques	0.65	0.75	0.75
Counter withdrawal	2.00	2.15	2.15
Telephone	0.30	0.35	0.35
Internet	0.20	0.30	0.30
ATM balance enquiry from own bank's ATM	0.15	0.00	0.00
Memo items:			
Number of free transactions (monthly)[d]	8	8	8
Range of minimum balances required to waive account-servicing fee[e]	500	500-1000	500-2000
Housing loans ($)			
Establishment fee	550	500	600
Monthly fee	5.25	5.25	5.25

(a) This table is based on public information on selected, widely-used bank accounts.
(b) Predominant charge in 1998 and 1999 for banks with such a charge. The latest observation is an average reading.
(c) Most fees are based on costs after the number of free transactions has been exceeded.
(d) For banks with such a facility. Within this figure, most banks allow fewer free over-the-counter transactions.
(e) For banks with such a feature. One bank does not have an account-servicing fee.
Sources: *Cannex,* banks' brochures and web sites.

Businesses

Banks' earn about $3.7 billion in fees from businesses, split roughly evenly between small and large businesses. Details of fees from businesses are set out in Table 3. Fee income from small businesses grew by 5 per cent in 1999. Fees from loans and bills to small businesses rose by less than the increase in credit itself, due to the continuing tendency for loan charges to fall. These lower charges seem to have been maintained so far in 2000 (Table 4). On the other hand, there appears to have been some rise in administrative fees on bill facilities over the past few years.

For large businesses, the combined increase in fees from loans and bills was 13 per cent, about the same as growth in credit from the banks surveyed.

Growth in 1999 in revenue from merchant service fees – fees earned from businesses from card transactions – was again high but broadly similar to growth in turnover on credit cards. This mainly reflects the increasing popularity of credit cards as a medium for making payments.

Table 3: Banks' Fees From Businesses
$ Million

	1997	1998	1999	Per cent change in 1999
Fees from:				
Small business				
– Deposits	165	205	240	17
– Loans	500	625	655	5
– Bank bills	290	270	265	–2
Total	955	1100	1160	5
Large business				
– Deposits	50	50	60	20
– Loans	355	345	415	20
– Bank bills	535	545	595	9
Total	940	940	1070	14
Merchant services	570	730	935	28
Other services	390	460	490	7
Total business	2855	3230	3655	13

Table 4: Fees Paid by Small Business on a Loan of $100,000
(Average Of Major Banks)

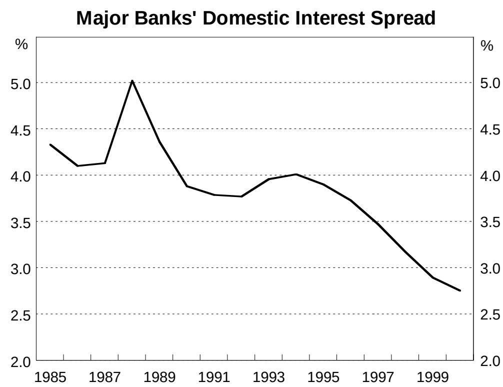
	1997	1998	1999	Latest
Loan establishment fee ($)	925	890	740	740
Overdraft fee (% pa.)	1.10	1.05	0.95	0.95
Term Loan fee (% pa.)	0.35	0.40	0.45	0.45

Source: Reserve Bank estimates based on information provided by banks.

Fees and Interest Margins

Banks' interest margins have contracted noticeably in recent years. This trend continued in 1999 as banks' overall domestic interest spread (measured as the average interest rate on loans less the average interest rate on deposits) fell by 0.3 of a percentage point, to 2.9 percentage points (Graph 2).[4] This interest spread has now narrowed by about 0.7 of a percentage point since 1997 and 1¼ percentage points since 1994; interest spreads for households and businesses have both fallen by about the same amount in this period.

Graph 2



As noted in the article in the *Bulletin* of June 1999, concern is sometimes expressed that banks have offset reductions in interest margins by raising fees. The latest information on fees and interest margins is consistent with the Bank's earlier conclusion that the fall in interest margins has significantly outweighed the rise in fees. In Table 5, the dollar value of aggregate transaction and account-servicing fees is expressed as a percentage of the dollar value of deposits; loan fees are expressed in a similar way relative to credit.

4 This spread fell by a further 0.1 of a percentage point to 2.8 per cent based on banks' interim results for 1999/2000. This narrowing of the interest spread, notwithstanding the rise in the structure of interest rates since late in 1999, implies that the average interest rate on banks' loans rose by less than the average cost of banks' funding.

Table 5: Estimated Costs of Fees on Deposits or Credit

	Level of Fees as a Per Cent of Deposits or Credit		
	1997	**1998**	**1999**
Households			
Deposits			
– Transaction fees	**0.10**	**0.16**	**0.20**
– Account-servicing and other	**0.13**	**0.14**	**0.16**
Total	**0.23**	**0.30**	**0.36**
Loans	**0.28**	**0.32**	**0.31**
Business			
– Small business credit	**1.65**	**1.74**	**1.65**
– Large business credit	**0.87**	**0.74**	**0.74**
Average of business credit	1.12	1.04	1.00

The main features of these data are that:

- as a proportion of average household deposit accounts, account-servicing and transaction fees rose in 1999, from 0.30 of a percentage point to 0.36 of a percentage point;
- on average, across all household loans, the amount added by fees was little changed in 1999, at about 0.3 of a percentage point;
- borrowing fees for businesses added an average of about 1 percentage point to the cost of a loan in 1999, a little less than a year earlier. This was due to a fall in fees paid by small businesses. When combined with the fall in interest margins, this has led to a clear fall in the cost of financial services to small businesses.

Even though there was some rise in deposit and transaction fees in 1999, increases in overall bank fees did not offset reductions in interest margins. Long-term data are not available but indications are that the same conclusion applies, as the **fall** in interest margins on loans to households and businesses of about 1¼ percentage points in recent years is greater than the overall **level** of fees. For households, this conclusion is true even when account-servicing and transaction fees are added to the fees charged on loans.

Conclusions

The available data cover only a very short time period, so it is not possible to draw firm conclusions. But at this stage, the Bank’s assessment is that:

- revenue from fees on household deposits and transactions is rising faster than underlying business volumes, reflecting rises in unit charges. Banks seem to be continuing to seek to recoup costs of providing payments services and administering household deposit accounts directly by fees rather than the previous practice of doing so indirectly through interest margins;

- revenue from fees on housing loans has fallen, though fees on other personal loans have continued to rise quickly; and

- revenue from fees on business loans has increased in line with underlying volumes for large borrowers, but significantly less quickly for small borrowers – ie for small business borrowers, fees per loan outstanding are falling.

The Bank's earlier overall conclusion, that the falling interest margins have not, on average, been offset by higher fees, continues to be supported by the latest data. This is particularly the case for housing borrowers and small business. However, banks' customers without a loan but with low balances and high transactions would not have benefited from these trends in banks' pricing practices.

Reserve Bank of Australia
SYDNEY

17 May 2000