RBA'S ANSWERS TO E-MAILED QUESTIONS

Inflation and forecasting

How confident is the RBA that its inflation forecast over the next two years when it cannot forecast growth over the same timeframe?

The RBA does make forecasts of growth over the next one to two years, though it is the forecast of inflation which is the most important. The inflation forecasts represent the RBA's best estimates based on information available at the time the forecasts are made. However, like all forecasts, they are subject to significant uncertainties. Some of the sources of uncertainty that have been important recently have been those associated with exchange rate changes, movements in international oil prices and shifts in the global economic outlook, particularly in relation to the United States. The Bank's regular monetary policy statements provide a discussion of these uncertainties in the assessment of the inflation outlook.

How does the Reserve Bank justify the pursuit of anti-growth policies (the maintenance of a three per cent upper limit on CPI) when there remains massive unemployment in this country?

The RBA's inflation target of 2-3 per cent is not an 'anti-growth policy' – it is pro growth. Low inflation provides an environment in which the economy can achieve its maximum sustainable rate of growth. This framework has delivered very good outcomes for the Australian economy, with an average inflation rate of around 2½ per cent since the early 1990s, declining unemployment, and one of the highest average rates of economic growth in the developed world.

Is the RBA Governor able to explain why a more growth-friendly level of inflation would not be appropriate for Australia?

2-3 per cent inflation <u>is</u> growth friendly, whereas periods of high inflation (most notably in the 1970s) were associated with a deterioration in economic performance and lower, not higher growth. The current low inflation environment has been associated with good growth outcomes and has contributed to the expansion being more prolonged than its predecessors in the 1970s and 1980s. A policy of tolerating higher average inflation would be detrimental to economic performance and would not generate higher growth of the economy or lower unemployment.

Is the RBA aware of strong statistical evidence of a positive link between moderate rates of strategic inflation (i.e. inflation other than that resulting from external shocks and printing money) and growth – specifically that historical statistical analysis proves that a strategic rate of inflation of at least three per cent is needed to maintain a sustainable growth rate, and that growth rates of five per cent or more will generate no more than five to seven per cent inflation rates?

A number of academic studies have looked at the question of what would be the optimal rate of inflation in the long run. These studies give a range of different answers, some concluding that it is best to aim for zero inflation, others arguing that a low positive inflation rate would produce better growth outcomes, and still others supporting a mild negative inflation rate. Despite these differences, there is widespread agreement on the broader point that inflation higher than the low single-digit level tends to be harmful to economic performance.

When the Government sets the inflation target for the RBA, is it the 'headline' or the 'underlying' rate that must be kept in that range?

Since 1998, the focus of the target has been the "headline" CPI.

Does the RBA consider that it has responsibility for ensuring that the inflation index it relies on is correct? For instance, does the RBA monitor changes made to the calculation of the CPI index by the Australian Bureau of Statistics and, when changes are made, obtain figures for comparison which show what index the calculation would have produced if the method of calculation (weightings) had not been changed?

Responsibility for the construction and accuracy of the CPI rests with the ABS, which has the requisite statistical expertise. Nonetheless, the RBA takes a close interest in these matters and has made submissions to the Bureau's periodic reviews of the CPI. With regard to the specific question, the RBA closely monitors movements in the individual components of the CPI and looks at the effect of any changes in the method of calculation. Generally, changes in CPI weights do not have a major effect on the index although conceptual changes such as changes to the measurement of housing costs can have a significant effect.

Does the RBA have any influence or input when the statisticians change the index?

Changes to the construction of the CPI are generally preceded by a public review process, in the course of which the RBA would typically make a submission. The RBA also participates in consultative groups of major users of economic statistics convened by the ABS. Nonetheless it is appropriate that decisions to change the CPI rest ultimately with the Australian Statistician.

Do the statisticians have to advise the RBA of their reasons for change, and justify them by reference to the international standards for calculating inflation indices? If this is not done by the RBA, is there any other body which does it?

The Statistician would typically announce any changes to the CPI in a public document explaining the reasons for the changes made. There is no requirement for the Statistician to report directly to the RBA though the ABS does correspond with the RBA on some matters. Australia's economic statistics are generally compiled in accordance with agreed international standards.

Australian dollar

Why is the Australian dollar low against the United States dollar and English pound, when the economy is growing at a faster rate?

The Australian dollar fell substantially between January 2000 and July 2001, particularly against the US dollar. Much of this fall was due to changes in the flows of capital associated with the technology bubble in global markets. During 2000, portfolio equity capital inflow to Australia by foreigners dried up, and then turned to substantial outflows, as global investors chased the promise of high returns in US equity markets. These flows turned back around to inflows from June 2001 onwards.

The US dollar, which was benefiting from the capital inflows coming from not only Australia but many other countries (including Europe), was independently strong. The result was that the Australian dollar fell by more against it than it did against most other currencies, such as the euro.

Since mid 2001, with the bursting of the tech bubble and the return of international capital flows to more normal patterns, currency traders are again looking at "fundamentals" such as comparative growth performance and interest rate differentials when deciding on their currency investments. The result has been that the Australian dollar has risen somewhat in 2002. At the same time, the US dollar has fallen, though it remains well above its average level in the first half of the 1990s.

Unemployment

Unemployment is costing the economy billions of dollars each year. What does the RBA Governor think the "natural rate of unemployment" is? If it is higher than five per cent, why is structural unemployment so high?

The Governor has no particular view on the natural rate of unemployment, and is on record as questioning the usefulness of that concept. The Bank does not specify *ex ante* a limit as to how far that process can continue. Rather than having a fixed limit in mind, the aim of policy is to promote continued expansion of the economy consistent with low inflation. Hence, over time, the policy framework will allow the economy to continue growing at a rate consistent with declining unemployment as long as that does not lead to an unacceptable build-up of inflationary pressures.

Interest rates

When the RBA lowers the cash rate, why does it take so long for the banks to change the rates on loans but when the cash rate is increased, the banks' timeframe for changing the rates is a lot quicker? Can the lag in the banks' timing of rate changes be regulated by the RBA?

For home loans it is no longer the case that banks take longer to pass on reductions in the cash rate than increases. This year, the banks have, on average, increased mortgage rates eight days after the increase in the cash rate. This is similar to the delay of nine days in response to reductions in the cash rate in 2001. However, for small and large business, it is the case that increases in the cash rate have been passed on to borrowers more quickly than have reductions.

	Tightening cycles			**Easing cycles**	
	1994 average	**1999-2000 average**	**2002 average**	**1996-1997 average**	**2001 average**
Housing	16	12	8	51	9
Small business	16	12	8	35	18
Large business	16	10	8	21	16

It is important to note that banks' overall cost of funds does not move exactly in line with changes in the cash rate. Banks source a large proportion of their funds from financial markets rather than depositors. These market interest rates, such as bank bill rates, typically rise and fall in anticipation of future changes in the cash rate, so banks' cost of funds can start to change well before the cash rate changes. In recent years, there has been a tendency for these market interest rates to pre-empt increases in the cash rate by a greater margin than decreases. Given these considerations, it is not always meaningful to measure lags in banks' interest rate changes relative to the cash rate.

Will banks increase interest rates given to term deposits and savings accounts? This would be welcomed by retirees.

Interest rates on savings accounts and term deposits do not always move in line with the cash rate as, in setting them, banks take into account a range of other factors, including market interest rates and their overall need for funds. Since the start of this year, rates on fixed deposits have increased by between 0.1 and 0.5 percentage points, depending on maturity. Interest rates on transaction accounts have not increased.

Credit cards

Does the RBA consider that merchants benefit from the use of credit cards by consumers? If merchants do benefit, why is the RBA proposing a number of changes that will shift the cost almost entirely onto consumers?

This is an issue which was discussed extensively in the RBA's Consultation Document. Merchants do benefit from accepting credit cards, particularly in getting a guarantee of payment but financial institutions charge merchants a merchant service fee averaging 1.8 per cent of the value of each transaction (and up to four per cent for smaller merchants) for accepting credit cards. Debit cards (EFTPOS) also provide merchants with a guarantee of payment, but generally for a lower merchant service fee. Because of restrictions imposed by the international credit card schemes, merchants pass their credit card costs into the general level of prices. Hence, the community as a whole – including the 40 per cent of Australians who do not have credit cards – bears the costs of the credit card system.

The RBA's reforms, which amongst other things will lead to a reduction in merchant service fees for credit cards, will promote a more efficient and lower-cost payments system in Australia, from which consumers as a whole will benefit. The reforms will not shift the cost almost entirely onto credit cardholders. However, some credit card issuers may seek a greater contribution to costs from those credit cardholders who are heavily subsidised under current arrangements, viz, cardholders who settle their credit card account in full each month.

Can the RBA indicate whether it will monitor the cost impact of its proposed credit card scheme changes and ensure that any reduction in the level of interchange fees will not result in cost increases and/or service reductions to credit cardholders? What can the RBA do to ensure the banks and other financial institutions that issue credit cards do not merely shift the cost recovery from between themselves to consumers?

Credit card schemes are organised in such a way that those who ultimately bear the costs of credit cards are not necessarily those who enjoy the benefits. The costs of credit cards are borne initially by the merchant which accepts credit cards, which then passes the costs into the general level of prices – hence, the costs are borne by all consumers, whether they use a credit card or not. Credit cardholders using the revolving line of credit also contribute to credit card scheme costs by paying interest rates significantly above rates on other forms of unsecured lending. However, cardholders who settle their credit card account in full each month contribute very little directly to credit card scheme costs.

The RBA's reforms will promote a more efficient and lower-cost payments system in Australia, to the benefit of Australian consumers, by ensuring that the fees facing credit cardholders are more reflective of the costs of producing credit card services. At the same time, by allowing new issuers into the credit card market, the RBA reforms will give a boost to competition. As experience in the residential mortgage market shows, it is the arrival or the threat of new entrants that will put pressure on all credit card issuers to keep their fees to cardholders down.

Why can't credit card interest rates be required to be reduced when other interest rates fall (eg mortgage and investment rates)?

Like all other interest rates, credit card interest rates in Australia are determined by market forces. When these rates do not move as much, or as quickly, as some other interest rates, competition is unlikely to be working as it should. One reason is that consumers may not shop around actively for lower interest rate credit cards because they believe (incorrectly as it often turns out) that they will not end up as borrowers. Another reason is that the credit card schemes in Australia impose restrictions on which institutions can issue credit cards. The RBA's proposed reforms will liberalise entry into credit card issuing by allowing non-financial institutions with skills and financial substance to be eligible to participate, provided they meet appropriate prudential standards. It is worth recalling that it was the entry of specialist mortgage originators that spurred competition in the residential mortgage market.

How can the RBA objectively examine the arrangements for credit cards when it earns significant revenues from the main competitor of credit cards: cash?

The Payments System Board of the RBA has a mandate to promote efficiency and competition in Australia's payment system, consistent with the overall stability of the financial system. The Board is carrying out its mandate by examining the price incentives facing consumers of different payment services and the strength of competition in providing these services. Where markets for payment services are not efficient and competitive, the Board looks to identify and remove any unnecessary restrictions. Reform of credit card schemes is only part of the Board's agenda in the retail payments area.

The RBA's traditional role as issuer of Australia's currency notes has no bearing on the Payment System Board's mandate. The RBA is simply the wholesaler of currency notes to the commercial banking system and provides whatever volume of currency notes is demanded; any profits from that activity are paid directly to the Government. It is the commercial banks that determine the cost of cash to the public by the charges they levy on consumers for cash transactions at branches and ATMs, and on businesses for distributing, collecting and depositing cash. Several years ago the RBA ceased providing subsidised specialised cash services. In its wider business, the RBA has actively promoted the adoption of more efficient payment methods. Over the last decade, for example, it has led the way in moving government payments such as pensions and other benefits from cheques, which are relatively expensive for both the Government and the beneficiary, to direct credits to accounts at financial institutions. These changes have increased the efficiency of the payment system and produced substantial resource savings to all parties involved.

Bank fees

Why is there a lot of emphasis placed by the RBA on interest rates, but very little on bank fees?

The RBA focuses on interest rates for monetary policy because it is through changes in interest rates that monetary policy is implemented. That said, the RBA does recognise the importance of bank fees in the overall cost of borrowing or running a transaction account. It collects, analyses and publishes a range of information on bank fees. Figures on bank fees are published in Table F6 of the *Reserve Bank Bulletin* and articles on bank fees are in the June 1999 and July 2001 issues of the RBA's *Bulletin*.

Structure and role of the Reserve Bank

Why is it that the Reserve Bank's Board members, particularly those representing businesses and the unions, are not encouraged to engage in active public debate over the stance of monetary policy, as they are in the United Kingdom?

The structures of the Reserve Bank Board and the Bank of England's Monetary Policy Committee (MPC) are very different and they operate in different ways. In addition to the Governor and Deputy Governor, the Reserve Bank Board is composed of a majority of "outside" members who are not full-time central bankers, plus the Secretary to the Treasury. The MPC is composed of five executive members of the Bank of England plus four external non-executive members all chosen for their expertise in monetary policy and who devote the majority of their time to the Bank of England.

The Reserve Bank Board is a decision-making Board and operates like most corporate boards in that when decisions are made they are announced and explained by the Governor, the Chairman of the Board, on behalf of the Board. For the MPC, while a single decision emerges from each meeting, the nine members are individually accountable for their judgments.

Given that the RBA is independent of Government and does not fully explain its decisions to the public, to whom does the RBA justify itself?

The RBA is independent of the Government in setting interest rates to achieve the agreed objectives for policy, but is responsible to Parliament for its actions. The RBA does fully explain its decisions. Changes in monetary policy are announced along with a detailed explanation, the next morning after the meetings of the Reserve Bank Board. The RBA also publishes *Statements on Monetary Policy* each quarter, providing a detailed analysis of the economy and financial markets and from time to time the Governor, Deputy Governor and senior officials give public talks on various aspects of the RBA's activities.

A further key element of the RBA's accountability is the twice-yearly appearance by the Governor, Deputy Governor and senior officials before the House of Representatives Standing Committee on Economics, Finance and Public Administration. At these public hearings, the most recent of which was of course in May, the members of the Parliamentary Committee question the Governor on a range of issues, particularly focusing on the conduct of monetary policy.

Why is it that the econometric models used by the RBA in its calculations are never made publicly available for scrutiny?

They are published. A comprehensive description of the RBA's econometric modelling work was most recently published in June 2000 as Research Discussion Paper 2000-05 and is available on the Bank's website (www.rba.gov.au). That said, modelling plays only a relatively small direct role in policy decision.

Can the Governor please explain why the RBA should be independent of the Australian people (by being independent from the Australian Government and therefore the voters), whose livelihood they affect through the operation of monetary policy?

The RBA is not independent of the Australian people. It is a Commonwealth statutory authority, established under an Act of Parliament, the *Reserve Bank Act 1959*. This Act gives the Reserve Bank Board the power to determine the Bank's monetary policy, but sets out the broad goal of that policy. The Government has confirmed the RBA's independence in the day-to-day operation of monetary policy in the 1966 *Statement on the Conduct of Monetary Policy* which was prepared to contribute to a better understanding in the community of the relationship between the RBA and the Government.

Recognising this independence, the RBA pays particular attention to ensuring it is transparent in explaining monetary policy actions and being accountable for its decisions. The twice-yearly appearances by the Governor, Deputy Governor and senior officials before the House of Representatives Standing Committee on Economics, Finance and Public Administration are an important part of the accountability arrangements.

Is the RBA a Government Department? If it is not, who are its shareholders?

The RBA is not a Government department. It is a Commonwealth statutory authority, established under an Act of Parliament, the *Reserve Bank Act 1959*. In other words, it is “owned’ by the Australian Government.

Reserve Bank of Australia
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