The Parliament of the Commonwealth of Australia

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

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

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Foreword

In this report the Committee deals with the November 1999 public hearing with the Reserve Bank of Australia, the Bank's 1998-99 Annual Report and the *Semi-Annual Statement on Monetary Policy*, November 1999. It also covers the first Annual Report of the Bank's Payments System Board. The public hearing was one of the Committee's biannual meetings with the Governor of the Reserve Bank that have become an important component of the Committee's work and the Bank's public accountability strategy. As a result of this process, the Parliament, financial sector and community each have a regular opportunity to understand the reasoning behind monetary policy decisions and to monitor the way in which the Bank conducts its other activities. There is an ongoing high level of public interest in the Governor's appearances before the Committee.

The benefits of the openness and accountability of the Australian financial system were apparent in the impressive performance of the Australian economy during the Asian financial crisis. With the tide of the crisis now receding, the Australian economy has emerged relatively unscathed. Despite the problems experienced by important trading partners Australia's growth rate continues to exceed 4 per cent and inflation is low. The Bank's steady approach to monetary policy has been widely acknowledged as a crucial factor in Australia's ability to withstand the crisis. However, since the hearing the bank has again increased the interest rate, from 5 per cent to 5.5 per cent.

In undertaking its examination of the Bank's operations, the Committee appreciates the assistance and cooperation received from Ian Macfarlane, Glenn Stevens, John Laker and their staff. The Bank's management and staff once again demonstrated an impressive level of professionalism in their approach to the public hearing and in the contents of the Annual Reports and the *Semi-Annual Statement* for November 1999.

The Committee also appreciates the briefings it received prior to the hearing from Mr Peter Osborne of Merrill Lynch, Professor Tom Valentine of the School of Economics and Finance, University of Western Sydney and Mr Peter Mair a Visiting Lecturer at Wollongong University.

I thank all 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

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
APRA	Australian Prudential Regulation Authority
ATM	Automatic Teller Machine
BCA	Business Council of Australia
CAD	Current account deficit
CPI	Consumer price index
EFPA	House of Representatives Standing Committee on Economics Finance and Public Administration
EFTPOS	Electronic funds transfer at point of sale
ESA	Exchange Settlement Account
GDP	Gross Domestic Product
GST	Goods and Services Tax
IFM	Inquiry into International Financial Market Effects on Government Policy
IMF	International Monetary Fund
PSB	Payments System Board

RBA	Reserve Bank of Australia
RTGS	Real-time gross settlement
Y2K	Year 2000

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Introduction

Background

1.1 The biannual appearances of the Reserve Bank of Australia before the House Economics Committee make up one of the major elements of the Bank's accountability to the Parliament.

1.2 In August 1996 the Treasurer, the Hon Peter Costello MP, and the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane, agreed on a *Statement on the conduct of monetary policy* which set out a common understanding between the Governor and the Government on key aspects of Australia's monetary policy framework. These arrangements extended and formalised the Reserve Bank of Australia's accountability framework by securing the Bank's agreement to the publication of two annual statements on the conduct of monetary policy and the appearance of the Bank Governor twice a year before the House of Representatives Standing Committee on Financial Institutions and Public Administration and subsequent committees (now the Economics, Finance and Public Administration Committee, EFPA) to answer questions about monetary policy and the other operations of the Bank.

1.3 This Committee and its predecessors have now held six meetings with the Bank under these arrangements and all participants are satisfied that the process is working efficiently and effectively. There is a considerable amount of public interest in the Bank's appearances before the Committee, as these provide the Parliament, the financial sector and also the wider community, with valuable insights into the way the Bank manages monetary policy.

1.4 The Committee's review of the Reserve Bank's operations is based on the Bank's semi-annual statements on the conduct of monetary policy and its annual reports. The basis for the review of Bank's annual reports is House of Representatives' standing order 324 (b) which provides for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make.

1.5 The terms of reference for the inquiry are on page ix.

Scope and conduct of the review

1.6 At its meeting on 10 December 1998 the Committee resolved to examine the Bank's Annual Report 1998-99 and related Semi-Annual Statements.

1.7 This report focuses on the *Reserve Bank of Australia 1999: Report and Financial Statements*[1], the first *Payments System Board Annual Report*[2] and the *Semi-Annual Statement on Monetary Policy, November 1999*[3], which were discussed at a public hearing in Sydney on 29 November 1999. Details of the hearing are in Appendix B.[4] In addition, because of the banks decision on 2 February 2000 to increase interest rates from 5 per cent to 5.5 per cent, some aspects of monetary policy were discussed with the Bank on 9 February 2000 as part of the Reserve Bank's evidence to the Committee's inquiry into international financial markets.

1.8 The Committee's review, while a public process is not formally advertised in the media (except as part of a general advertisement in *The Australian* in November 1999 for House of Representatives' activities). However, it is well publicised before the hearings.

1.9 Prior to the November hearing the Committee held private briefings with economists and others from the financial sector. On this occasion the people chosen were Mr Peter Osborne of Merrill Lynch, Professor Tom Valentine of the School of Economics and Finance, University of Western Sydney and Mr Peter Mair, a Visiting Lecturer at Wollongong University. These briefings presented to the Committee some alternative views on monetary policy, the Australian economy, the international economic outlook and the operation of the Bank.

1.10 The detail of the Bank's views are set out in its annual report and the semi-annual statement. In this report, the Committee highlights the significant matters raised at the public hearing, many of which are concerned with monetary policy, but some of which are more broadly focused on financial system stability and other issues.

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

2 Reserve Bank of Australia. *Payments System Board Annual Report 1999*. RBA, Sydney, p 34.

3 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November 1999*. RBA, Sydney, p 45.

4 A copy of the transcript of evidence from the hearing has been published by the Committee and is available from its Secretariat or from the Committee's internet site: http://www.aph.gov.au/hansard/reps/committee/r2791.pdf

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Conduct of Monetary Policy

Review of June 1999 forecasts and future prospects

2.1 The hearing began by looking back at the economic forecast the Governor presented at the previous hearing with the Committee in June 1999. He noted that at the time of that hearing a slowdown in GDP growth was anticipated but that there was '…a fair bit of uncertainty…'[1] about its likely extent.

2.2 He said that the level of uncertainty existing at the time led the Bank to project a relatively wide range of possible GDP growth rates for calendar year 1999. It was projected that GDP growth would be between 3 and 4 per cent, compared with 4.5 per cent for both 1997 and 1998.[2]

2.3 The Governor said that the position has now clarified. The Bank is now anticipating growth of 3.5 per cent for calendar year 1999 and 4 per cent through financial year 1999/2000. These figures are in accord with Treasury's mid-term projections.

2.4 The Governor continued by saying that there had been a modest decline in Australia's rate of growth, brought about by the low growth figure for the June quarter, a weakness in business investment and a decline in exports in the first half of 1999. He said that these effects were now mainly behind us and that stronger growth could be expected in the year ahead.[3]

2.5 The November Semi-Annual Statement highlighted a continuing expansion of domestic demand – fuelled mainly by strong household

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1 Evidence, p 2.
2 Evidence, p 2.
3 Evidence, p 2.

consumption expenditure and some temporary factors such as the proceeds of demutualisations and capital gains from privatisations.[4]

2.6 The Statement said that underlying the strength of domestic demand are several factors: growing incomes, sustained high levels of confidence, low borrowing costs, wealth gains over a range of assets, a recovery in the housing sector and the prospect of increased investment spending over the next twelve months. The external environment has also improved and is adding strength to Australia's growth prospects. Australia is now in the ninth consecutive year of economic expansion.[5]

2.7 The other main indicators performed roughly as expected. Inflation in the CPI was, as predicted, about 2 per cent for 1999, with the underlying inflation rate slightly higher. These rates are expected to increase a little in the period to June 2000. For the CPI a rate of 2.75 per cent is anticipated, with the underlying inflation rate lower at 2.25 per cent.

2.8 Continuing the movement observed at the last hearing, unemployment has again fallen slightly. Over the three months of the September quarter, the unemployment rate averaged 7.2 per cent compared with 7.5 per cent for the equivalent period prior to the June meeting with the Committee[6] and 8.1 per cent a year earlier. The November Semi-Annual Statement reported that employment growth was strengthening toward the end of the year. In the four months to September employment increased by 120,000, much of this in full time employment.[7]

2.9 The February 2000, Reserve Bank Bulletin confirmed this trend by reporting that employment growth had strengthened to an annualised level of 3½ per cent in the December quarter, its strongest performance in four years. The Bulletin also noted that unemployment was just under 7 per cent in that quarter, its lowest level in almost a decade.[8]

2.10 Similarly, the result for the current account deficit (CAD) was as expected. The Bank had anticipated a quarterly CAD of 6 per cent of GDP and it reached that level in the June quarter and could remain there throughout the current financial year.

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4 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 1.

5 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, pp 1-2.

6 Evidence, p 3.

7 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 22.

8 *The Economy and Financial Markets*, Reserve Bank of Australia. *Bulletin,* February 2000. JS MacMillan, Sydney, p 1.

2.11 The Governor commented that:

> …It was surprising that the current account did not deteriorate faster and further, given the disparity between our growth rate and that of our trading partners. While the slowness of the deterioration has been a pleasing development, we think that the improvement could be some time in coming.[9]

2.12 "In summary, [the Bank is] expecting that the current financial year will be another good one for the economy. …"[10]

Interest rate increase

2.13 The main issue discussed by the Governor in his opening remarks was the decision taken at the Bank's board meeting in November to increase the key interest rate, the overnight cash rate, from 4.75 per cent to 5 per cent. To assist the Committee he reviewed some of the reasons behind that decision.[11]

2.14 The Governor said that although Australia has an independent policy, international issues are very important and are a common background for all countries. The major development in the international scene was the substantial change in the world economic outlook. The effects of the Asian crisis produced a weak performance in the world economy in 1998 and there were expectations that 1999 would be weaker still. However, the world economy recovered strongly in 1999 and 2000 is now expected to be stronger again.

2.15 He noted that the result of stronger world growth had been to push up interest rates in most industrial countries. Australia's tightening of rates was mirrored in the USA, the UK, the European Central Bank, Sweden, Canada and NZ.[12]

2.16 The Governor was asked by the Committee whether, given the trend in market rates revealed by the Semi-Annual Statement, he could rule out a further interest rate increase in the next six months. He responded:

> I cannot really rule out anything – and never have been able to – but I would like to make a few comments on the behaviour of market interest rates … They were forecasting an interest rate increase for about five months before anything happened. So the

9 Evidence, p 3.
10 Evidence, p 3.
11 Evidence, p 3.
12 Evidence, pp 3-4.

> fact that they are forecasting something does not mean that it is ever going to happen, and it certainly does not mean that it is going to happen quickly.
>
> … the 90-day or the 180-day rates do contain a forecast of interest rates but they are not necessarily any more accurate than any other interest rate forecaster. Sometimes they get it right; sometimes they get it wrong. Often they get it right in the very long run but they get it wrong for a long time before they get it right.[13]

2.17 The Committee sought the Governor's view on whether the increase in consumer confidence after the rise in interest rates, was a cause for concern - whether the rate increase should have been bigger? The Governor said:

> …One way of viewing it is that the consumers think that it was a very sensible, pre-emptive move, and it has increased the probability of sustained expansion.[14]

2.18 When asked whether the Bank was worried that its forecasting of growth had been in error recently and that made pre-emptive corrections more risky, he responded:

> … every approach to monetary policy has got difficulties and we think this is the best available. You are right that we have forecast a slowdown for some time and it took a long time to come. The great irony is that it came after the Asian threat passed rather than whilst the Asian threat was upon us. But I think in the broad sweep of history forecast errors of that size are actually quite small…It is not as though we were forecasting something which never occurred or that we were forecasting the economy was going to go one way and it clearly went the other way with a vengeance. My feeling is that, over the past two or three years, the forecasting record has been not brilliant but better than average by the standards of economic forecasting.[15]

2.19 The Committee will continue its interest in the Bank's assessments of economic growth and the monetary policy decisions arising from them.

2.20 The Bank referred to this issue again in its Media Release on 2 February 2000 in which a further interest rate rise of 0.5 per cent was announced. Commenting on the likely course of growth rates following the rise, the Bank said:

13 Evidence, p 7.

14 Evidence, p 18.

15 Evidence, p 18.

> …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...[16]

2.21 Continuing its assessment of the effect of this additional rise in interest rates, the Bank said:

> …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 which has been in place until now.[17]

2.22 The Committee wanted to know whether the decision to raise the cash rate in November was as much a psychological message to the economy as anything else? The Governor responded:

> I think there is an element of that. It would have looked very strange. We were growing faster than these other countries. If we had said, ‘No, in our view of the world, it’s still a weak outlook,’ I think we would have looked very strange.[18]

2.23 On the February increase in the cash rate, the Committee was concerned at the size of the increase and why it seemed to be higher than other countries had found to be necessary. During the Inquiry into International Financial Market Effects on Government Policy (IFM) public hearing, the Bank denied that the increase was higher than increases in comparable economies:

> It is not true that the others all went 25 [basis points]. I note that the UK, for example, and New Zealand both had a 50 and a 25, just the same as we did. I think the US is different in that the US is very sensitive, particularly to its stock market, and I think the US has to tread perhaps rather more gingerly than some of the other countries.[19]

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16 Reserve Bank of Australia. *Statement By The Governor, Ian Macfarlane: Monetary Policy,* Media Release, 2 February 2000. RBA, Sydney, p 2.

17 Reserve Bank of Australia. *Statement By The Governor, Ian Macfarlane: Monetary Policy,* Media Release, 2 February 2000. RBA, Sydney, p 2.

18 Evidence, p 14.

19 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000,* p 2.

2.24 The Committee were also concerned about press speculation that the latest increase in interest rates would weaken Australia's bid to become a financial centre for international money markets. The Governor did not agree that the rise in interest rates would affect that situation at all – in fact, he suggested that if Australia had **not** increased interest rates, that would have been more damaging:

> … I cannot see a mechanism whereby raising interest rates in a responsible manner, as has been done here and has been done in a number of other countries … could in any way be construed as being detrimental to their growth as financial centres.
>
> … In fact, I think if we had have tried to defy gravity, it might have been harmful. But by doing the sensible thing, I do not think it has done any harm at all.[20]

The Bank's approach to monetary policy

2.25 At the November hearing, to give the Committee some guidance on the reasoning behind the Bank's recent policy decisions, the Governor outlined in some detail the philosophy behind the Bank's approach to monetary policy. He said that his comments would illustrate that with the easing of contractionary influences from abroad and the beginning of inflationary pressure, the expansionary monetary policy settings which had been operative were no longer appropriate for the circumstances. This, he said was the basis of the decision to tighten monetary policy.[21]

2.26 The Governor used two illustrative examples – the first where inflation is running at or about 2 per cent and the economy's performance is near optimal, with no apparent pressure on the inflation rate to move either up or down. The second covered the situation where the inflation rate is running either above or below the average level expected by the Bank.

2.27 He said that in the first case, a situation of dynamic equilibrium, the Bank would see no need for policy action. Small variations in the inflation rate would also be ignored. The Bank would not plan on intervention unless there were forecasts of a substantial shift in the rate of inflation (say, 1 per cent or more) which was also expected to last for some time.

2.28 In the other case, however, the situation is one of dynamic disequilibrium and the Bank would seek to take action which would return the rate of

20 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000,* p 3.

21 Evidence, p 4.

inflation to the required range. The specific policy action applied would, of course, depend on whether the current inflation rate was above or below the expected range.

2.29 If inflation were higher than desired, the Bank would raise interest rates to a level designed to reduce inflation to within the target range. Once that process had properly commenced, interest rates would be gradually eased to provide a “soft-landing” within the target range and avoid the tendency to “overshoot”.

2.30 The other case of a situation where the inflation rate is lower than the target range would be handled in a similar way – except that interest rates would be eased to encourage the inflation rate to return to the expected range. The Governor noted that:

> …The framework does not envisage the low interest rate setting being maintained until something goes wrong.[22]

2.31 The aim is to use small adjustments to the settings to allow corrections to take place smoothly. The Governor referred to the Bank’s policy as pre-emptive, but acknowledged that many people would prefer that adjustments only took place when forced by circumstances such as, for example, the economy already overheating.

2.32 Queried about his use of the term pre-emptive, the Governor explained:

> The term ‘pre-emptive’ was used mainly to distinguish it from a rather old-fashioned approach to monetary policy where you actually wait for clear evidence of overheating before you tighten monetary policy. We were saying that the economy is in good shape: growth is in a reasonable corridor and so is inflation. Yet there is a case to tighten monetary policy because, as we said, the stance of monetary policy that brought inflation back to the target is not the stance that you would use to maintain it within the target. And so it is pre-emptive in that it happened before the indicators of overheating. If it were done perfectly – and I am not sure anyone has ever done it perfectly – those indicators of overheating would never occur.[23]

2.33 In its Annual Report the Bank commented:

> …Although changes to monetary policy are infrequent, the Bank needs to transact in the money market on a daily basis to ensure

22 Evidence, p 5.

23 Evidence, p 10.

> that conditions do not depart too far from those consistent with the desired stance of monetary policy...[24]

2.34 In the Media Release on the February interest rate increase, the Bank expanded on the reasons behind the decision, by describing its overall view and the likely effects of the change:

> 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 the 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.[25]

2.35 It is interesting to note that in November, during discussion of the Bank's policy, the Governor was asked what rate of interest would be considered neutral. In response, he said:

> Everyone would like to know what the neutral stance of monetary policy was and what set of interest rates represents neutrality. I do not know of any country that has ever been able to nominate that. … If you did attempt to define neutral, it would be neutral in light of the economic environment that you are in. If the economic environment … changed over the next three months, you would then want to move your interest rates in line with that …
>
> We are not saying, when we raise rates, that the economy has turned the corner and is rushing away – far from it. Literally it is not and is growing more slowly in calendar 1999 than it was growing in calendar 1998 or calendar 1997. What we are saying is that the threat of a big contraction seems to have receded, so the balance of risks has changed… If you do not have that threat to

24 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999*. RBA, Sydney, p.6.

25 Reserve Bank of Australia. *Statement By The Governor, Ian Macfarlane: Monetary Policy,* Media Release, 2 February 2000. RBA, Sydney, p 2.

> contend with, you do not want to have a setting that is expansionary such as those you had particularly in 1998 and the first part of 1999.[26]

2.36 When giving evidence to the Committee's IFM inquiry, the Governor was questioned about the role played in the Bank's decision making process by the actions of other central banks around the world.

2.37 He said that the actions of other central banks were a secondary matter in setting Australia's monetary policy. Most of the time monetary policy is made strictly according to the needs of the Australian economy. Only occasionally, such as in a financial crisis, do international developments assume an important role in that process. The Governor stressed, however, that his comments did not mean that the international scene could be ignored:

> That does not mean that the international environment is not important. The international environment can be very important because it can be a major determinant on how we see growth and inflation developing in Australia, so we have to act in an international environment. But in no sense is there a process whereby we are either coordinating it with other central banks or sitting on the edge of our seat waiting to see whether someone has moved so we might move. That is not the process. The process is that we look at the needs of the Australian economy and we act in light of that.[27]

2.38 The Governor commented at the November hearing that there were also attempts to attribute a political dimension to the Bank's decisions but denied that adjustments are politically motivated. He noted that some commentators attributed the November interest rate increase to a fear of the likely inflationary effects of the GST. If that were the case, he asked, why had the other major industrial nations also tightened their monetary policy? None of those countries is about to introduce a GST. The Governor said that the Bank expected the inflation rate to be within the target just before the GST is introduced and back within the target a year later:

> This view … is based on the assumption that there will be no second round effects due to higher wage outcomes or opportunistic pricing behaviour … If we start to observe

26 Evidence, p 9.

27 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000*, p 1.

> behaviour that indicates that this assumption was not correct, then monetary policy would act upon it. We are not acting at present on the expectation that this assumption will be violated; we are acting on the assumption that it will hold.[28]

2.39 At the IFM hearing in February, the Governor was asked if he could categorically rule out the GST as a factor in the November 1999 and February 2000 interest rate increases. He replied:

> Yes. I have no trouble in ruling that out at all… We would have put up interest rates by three-quarters of a per cent whether there was a GST impending or whether there was not a GST impending.[29]

2.40 The Committee said that the idea was often put forward that, in practice, there are really two Australian economies. The first based around Sydney and Melbourne and growing quite strongly and the other covering other parts of the country and certainly not growing well. What weight was given to that concept in the Bank's decision making?

2.41 The Governor responded that:

> … People say, 'You've got such and such a monetary policy but it's not suitable for this region or that region.' I think it is the same thing when we look at the economy more generally. There are businesses, there are households, and all sorts of expenditure is going on. You have to choose a monetary policy which is, on average, the right one for the country. There might be some parts of the country where people are expanding too fast and some parts where they are not expanding fast enough. There may be some business or household entities which are running overstretched balance sheets. There are other parts that are not. All we can do with monetary policy is come up with the right policy on average for the country.[30]

2.42 The Governor also said that in any large economy there will always be some sectors growing faster than others. He said that to separate Sydney and Melbourne in that way was an oversimplification:

28 Evidence, pp 5-6.

29 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000*, p 2.

30 Evidence, pp 19-20.

> … There are a lot of other parts of the economy that are doing very well; there are a lot of other parts of the economy that are not doing very well. …
>
> It is true if you go down to much smaller units, probably within New South Wales or even smaller units within the Sydney metropolitan area, that you can find some areas that are going very fast and other areas that are not. But I do not think that anyone has established that the disparity between the strong and weak areas is any greater than it has ever been. I think this is an ongoing feature of any large economy, that there will be some areas that are growing much stronger than average and other areas that are growing less strongly than average.[31]

2.43 At the IFM inquiry hearing, the Committee resumed this line of questioning and asked whether other central banks had a mechanism to take into account regional differences when setting monetary policy. The Governor reiterated his previous response, that there could only be one monetary policy – he used as an example the recent European decision to form a monetary union, where each of the nations involved relinquished their own monetary policy and accepted an overall policy to apply to the whole of the European Union. He then compared that situation to the Australian colonies deciding on Federation and similarly giving up their independent monetary policies. The Governor concluded, by saying:

> … I do not think there is anything we can do about the fact that you can only have one monetary policy for a country.[32]

International issues

2.44 The Committee noted comments in the November Semi-Annual Statement which indicated that the Japanese economy was showing signs of recovery.[33] Bearing in mind the importance of Japan to Australia's trade prospects, the Committee queried whether, in the Bank's opinion, the recovery was now established? If so, is it likely to be a sustained recovery?

2.45 The Assistant Governor (Economic), Mr Stevens, replied that GDP in Japan had grown in each of the previous two quarters and that further growth was expected in the recently completed September quarter. There

31 Evidence, p 8.

32 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000,* p 4.

33 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999.* RBA, Sydney, pp 3-4.

is still reservation among analysts, however, because the initial stages of the recovery have been heavily dependent on very large government funding packages. The question which remains is: what will happen in the medium to long term when that effect is no longer there? In the short term, the stimulus will continue, as the Japanese Government has announced another financial support package to take the economy through into next year.[34]

2.46 The Assistant Governor (Economic) added that there are other promising signs in the Japanese economy, particularly indications that the private sector is starting to respond to the Government's efforts at stimulation:

> … the evidence so far this year seems to be that private spending has begun to grow.
>
> We also see some improvement in business and household confidence. They are still quite weak and there is a long way to go there but there are a number of quite encouraging signs, so I am cautiously optimistic that Japan will record growth this year. All the forecasters are now putting in positive numbers for 1999 – quite a change from six months ago. I think that, if they can get that growth this year, it is likely that Japan will continue to grow gradually through into next year. As you say, if that turns out that is very advantageous for us.
>
> … Japan itself is actually starting to benefit a little from the recoveries in other economies in the region because their export performance is starting to improve. … So one would not say that Japan is completely out of the woods yet but there have been a number of encouraging signs this year.[35]

2.47 The Committee was interested to know whether the recovery in Japan and in a number of other Asian economies would result in pressure towards increased commodity prices – an issue of obvious importance for Australia. The Bank said that some commodity prices had already increased, notably the sharp increase in oil prices. Unfortunately, the prices of the commodities of greatest interest to Australia, such as coal and iron ore, have so far changed very little.[36]

2.48 While discussion centred on commodity prices, the question was raised as to the likely outcome should the Australian dollar rise too quickly, in advance of rising commodity prices? Would that put a brake on

34 Evidence, p 36.

35 Evidence, p 36.

36 Evidence, p 36.

Australia's export growth? The Governor said he was not very concerned about that:

> …The Australian dollar is not showing a tendency to move up. It is possible at this stage of the cycle it might happen but it has not happened on this occasion. That is one of the reasons why I said … that the exchange rate has not been the significant input into decisions on monetary policy this year.[37]

2.49 The Committee sought the Bank's comments on the suggestion that financial restructuring in Asia is outstripping corporate restructuring. The Governor's response was:

> It does not really concern me. I think you were alluding to the fact that there has had to have been big restructuring of banks. They have such bad loans that many of them simply could not continue to operate unless the government stepped in and took the bad loans off their books. The government fixed up each respective bank, turned it into a good bank, doing all the standard things that you do when you have a financial crisis. That is happening, although it is not happening as fast as we would like…[38]

2.50 In regard to the Asian financial crisis, the Bank's Annual Report noted that:

> …The Asian crisis, at least as far as it affected financial markets, seemed to have largely passed… the general assessment of world economic and financial prospects was much more positive than it had been for the previous couple of years, providing a benign backdrop for Australian markets.[39]

2.51 The Committee referred to comments in the Semi-Annual Statement which discussed the strength of the Asian recovery process but highlighted continuing difficulties in Indonesia, Thailand and Hong Kong.

> …For many of these economies, GDP is approaching or exceeding pre-crisis levels … The exceptions are Indonesia and Thailand, where the financial problems have generally proven to be less tractable, and Hong Kong, where growth has been constrained by high real interest rates and the decline in asset prices. But even in these three countries, output has increased noticeably from its trough.

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37 Evidence, p 37.

38 Evidence, p 39.

39 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, p 9.

> The main contributor to the recovery thus far has been the increase in domestic demand, particularly private consumption…[40]

2.52 The Bank noted that Indonesia's recovery was noticeably weaker than the other Asian countries. In addition, it called attention to the heavy burden of restructuring the banking systems in both Indonesia and Thailand; in each case an estimated cost of 20 to 50 per cent of GDP. Commenting particularly on Indonesia's problems, the Bank said:

> … That is not surprising, given the depth of the problems they have had and the compounding effects of political uncertainty and so on over the past year. Both in that case and in the case of Thailand to a lesser extent, the financial problems are serious. … Those things cannot be done overnight. So they are a factor which I think makes it hard to get a strong recovery in the short term...[41]

2.53 The Committee followed up this line of questioning, by asking about progress internationally in improving financial systems to ensure that such a crisis would not occur again. The Governor said:

> I think some progress is being made. In fact, a lot of progress will be made, but whether it is enough, I do not know. The countries in question, the countries that got into difficulty, have set in motion a whole lot of changes. I do not think they will ever have banking sectors that are as sloppily supervised as they were. I think they will probably get quite big improvements in company law, bankruptcy procedures and accountancy standards that come out of this. So, at the level of the countries that were affected, I think there are some very big changes being made.
>
> At the level of the countries that were the ones that put the capital in and then took it out, there are also some changes, but not huge changes. For example, on the issue we have talked about, hedge funds, I think there will be some significant improvements made in the disclosure that hedge funds have to make. I think that will be one of the outcomes, which will be a good outcome.[42]

2.54 The Governor went on to comment about the current international attitude toward the IMF's policies and the role played by the US in the Asian financial markets:

40 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999.* RBA, Sydney, p 5.

41 Evidence, pp 36-37.

42 Evidence, p 37.

> There has also been a change of intellectual climate in that, with respect to the tendency for the IMF and the US to use whatever pressure they can to get countries to open up their financial markets or their international capital flows prematurely, I do not think we will see much of that for a while. I think they have backed off. ...[43]

This confirmed the Bank's earlier stand on this matter.[44]

2.55 The Bank was asked whether, from the tenor of some of its comments, the Committee should draw the conclusion that the Asian crisis was not necessarily over as yet? The Assistant Governor (Economic) replied:

> It depends on what you mean by the word 'crisis', I suppose…
>
> But, generally speaking, the period of contraction in economic activity and the maximum period of financial distress have clearly passed but there is the fall-out from those events in terms of an overhang of bad loans, the need to recapitalise banks and repair corporate balance sheets and things like that… So that kind of fall-out from the crisis is still with us but the period of contracting output and the period of maximum financial distress have passed.[45]

2.56 In view of the problems in Asia, the strength of the US economy and the strengthening outlook in Europe, the Committee sought the Bank's comments on whether exporters should be focussing their export efforts on those areas rather than Asia. The Bank indicated that this was an area best left to the exporters themselves. The Governor commented:

> Our exporters sell their products wherever they can find some demand and I do not really think that I should tell them, 'Look at this market and not that market.' It was possible that there was a time when we became a bit single-minded on Asia, but the Asian crisis certainly put paid to that. One of the most impressive things in the first year of the Asian crisis was how the exporters were able to diversify their markets very quickly, so I have confidence that our exporters and our export marketers know what they are doing.[46]

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43 Evidence, p 37.

44 House of Representatives Standing Committee on Economics, Finance and Public Administration. Review of the Reserve Bank of Australia Annual Report 1997-98, Interim Report, February 1999. Canprint, Canberra, para. 2.26, pp 8-9.

45 Evidence, p 38.

46 Evidence, pp 37-38.

Commonality between US and Australian interest rate policy

2.57 The Committee referred to suggestions that Australia seemed to be following the US trend on interest rates. The Governor did not agree and responded:

> I would resist that one strongly. If you look over longish periods, like whole business cycles, there is a world business cycle. …
>
> There is some commonality between all countries. On the other hand, if you tried to make a living by simply assuming that Australia moved interest rates at the same time as the US, you would lose a lot of money. …[47]

2.58 In a response consistent with his comments at previous hearings, the Governor compared the operation of interest rate policies in the US and Australia in 1997, 1998 and 1999. He noted that in March 1997, the US raised interest rates but Australia reduced rates twice in that year. In 1998, the US reduced interest rates three times and Australia made only a slight reduction at the end of the year. Similarly, in 1999 the US reduced interest rates a couple of times before Australia acted.

2.59 He compared the speed and magnitude of the changes and said that Australia's policy to move more slowly and in small increments, had been justified by the events of the last two years. He said that Australia had not needed a large increase in rates in 1999 because it had not followed the three rapid reductions by the US in 1998 – therefore a small increase was all that was needed to restore the balance:

> … we did it in a rather considered way. So if you look over that period there is some similarity, but the similarity is caused by the underlying world cycle. In terms of timing, of the amount that we went, they are very different.[48]

2.60 The Committee said there had been considerable speculation about a possible collapse on Wall Street. What would be the likely effects in Australia if that occurred? The Governor responded that this was a prospect which had been expected for some time but, despite substantial falls on a couple of occasions, it still had not eventuated:

> We have been living for quite a while with the possibility that Wall Street could collapse. It has not happened. We have had a couple of occasions in the last three years where Wall Street has actually gone down by 20 per cent. When you say that people are

47 Evidence, p 13.

48 Evidence, pp 13-14.

> surprised, they did not notice it but it happened on two occasions - once in 1997 and once in 1998. We could have a massive fall in Wall Street. I do not put a high probability on that and, even if it did happen, it is not clear that its economic effects would be as catastrophic as a lot of people assume. If we go back to 1987 when we had a very sharp fall - 22 per cent in one day on Wall Street - a lot of people were thinking the end of the world was nigh. That did not happen. In fact, 1988 turned out to be quite a strong year for the world economy.[49]

2.61 He then sought to clarify the different circumstances which could indicate whether or not an economy was vulnerable to a collapse of that kind:

> If it is only one asset class that falls sharply - for example, shares - and if the appropriate monetary policy response is forthcoming, it is not clear to me that you should assume that there is going to be an economic disaster. I think the economic disasters have been where it has not been just one asset class but a whole range of asset classes which have boomed, particularly where banking sectors have been very susceptible to very high loan valuation ratios on assets which fall and then we have banking sector collapses. You do not have to go back a long way to find that example in the US. So it is there. It is hanging around in the background. It is a nuisance, but I do not put a high probability on that sort of disaster scenario.[50]

2.62 In the Bank's evidence to the IFM inquiry, there was some discussion of the vulnerability of the US stock market to changes in monetary policy. The Governor asserted that this was a problem peculiar to the US and did not affect countries such as Australia, New Zealand, Canada and the UK to anywhere near the same degree:

> … I think the US has this additional complication that other countries do not have or the other countries to a very much smaller degree. You can observe it every time Chairman Greenspan makes a speech. The stock market either goes up or goes down on that speech. Every time there is speculation about an interest rate going up by X amount, the stock market changes. If that speculation changes, the stock market changes again. There is a sort of cat and mouse game going on in the US between

49 Evidence, p 19.

50 Evidence, p 19.

> monetary policy and the stock market to a much greater degree than there is in any other country.[51]

2.63 When asked about the likely flow-on effects of this situation, the Governor commented:

> … there are some people who think that if monetary policy is not handled with great subtlety in the United States there could be a big reaction in the stock market. We could have a big fall in the stock market. … [However,] I think, looking back… we can see that with sensible monetary policy a big correction in the stock market need not necessarily have very serious macro-economic effects. So I am not in the pessimistic school there… although I certainly do not rule out that a major correction will occur.[52]

Fiscal policy

2.64 The Committee referred to Treasury projections which indicated that fiscal policies would provide a modest stimulus to the economy in 2000 and 2001. The Governor was asked whether that situation complicated the management of monetary policy and whether it would make a tightening of interest rates more likely?

2.65 He replied that the Bank was aware of the factors producing that stimulus and these had been factored into the Bank's forecasts.[53] Referring to the Bank's projections for the coming year, he added:

> … through calendar 1999 our forecast as I indicated to you, was 3½ per cent. We think that as we go through the financial year, it is going to be running about four-ish and picking up a little bit the following financial year, maybe 4¼ or something like that through the following financial year. And that includes the fiscal expansion. Our judgement is that with careful management the economy will be able to handle a development of that nature, that the economy is not overheating, not wanting to run away. It has stepped down a little cog, slowed down for a little while, and then

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51 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000*, p 2.

52 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Inquiry into the International Financial Market Effects on Government Policy: Committee Hansard, Sydney, 9 February 2000*, p 2.

53 Evidence, p 9.

> it is moving back towards what should be a reasonable long-term growth rate.[54]

2.66 The Committee commented that the projected surplus for 2000-01 was $500 million in a budget of $160 billion. After a long period of growth, the Committee said, that could be described as 'paper-thin'. The Governor was then asked what pressure the deteriorating budgetary position was putting on monetary policy? He commented:

> Not a lot. It is hard to say that there has been a significant deterioration in the budgetary position. It is true that the surplus is going to be a little smaller than the surpluses that were projected a year or so ago, but that reduction in the surplus, as someone mentioned earlier in the proceedings, is equivalent to somewhere between a quarter and a half a per cent of GDP fiscal stimulus. As I said, we already have that factored into our forecasts. The state of the economy is such that it should be able to be absorbed without any particular problem. ...[55]

2.67 To a further question on whether large surpluses should be expected at this part of the growth cycle, the Bank said:

> … given that 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 later years of an expansion? The answer is: yes, in principle, I think you should. But things do not always work out that way. … I think the evidence in other countries is that, even though it is possible to run large deficits for a time, it seems to be rather difficult to run large surpluses for any length of time. The democratic process is such that people say, "Why are you taking all these taxes off me if you don't even need to spend them?"[56]

2.68 The Governor added some further comments about the current fiscal position in Australia:

> On the bright side of our fiscal position in Australia, we should look at the ratio of government debt to GDP. If you look at that, we are in pretty good shape. Our government debt to GDP ratio is either the lowest in the OECD area or the second lowest. I cannot remember which, but it is extremely low. So the government has not been making big demands on savings. Actually, it has not been

54 Evidence, p 10.
55 Evidence, p 21.
56 Evidence, p 21.

> making any demands in net terms on savings for a few years now, and it has been repaying debt.[57]

2.69 The Committee was interested to know whether the Bank agreed with the view expressed by the Treasurer in October 1999, that a strong case could be made for devoting future budget surpluses to higher infrastructure development to enhance economic growth? The Governor commented that in that case it would no longer be a surplus. However, he continued:

> … You are saying that you spend it on infrastructure so you do not develop a big surplus. I have no objection to infrastructure development, and I think, if you were in this hypothetical case where you had this massive looming surplus, that would have a fair claim to be up there along with a number of other priorities as to what to do with it. My guess is that someone will find something to do with it before that occurs.[58]

2.70 The Committee asked if any calculations had been made of wealth gains and capital speculation which might follow from changes introduced by the Ralph business tax review and the cut to the capital gains tax? The Governor said he was not sure what the effects would be:

> … One effect would be a whole lot of people who have been reluctant to sell might suddenly sell. It is not clear what effect it would have on asset prices. In the long run presumably it would tend to push them up but in the short run it may well have the opposite effect.

He said that the Bank would continue to monitor asset prices.[59]

2.71 The Committee sought the Bank's opinion on the recent proposal by the Business Council of Australia, that fiscal policy should be made by an independent authority, in a similar fashion to monetary policy. The BCA proposal envisaged a mechanism which would allow more sensitive finetuning of fiscal policy.

2.72 The Governor responded that he admired the type of lateral thinking which had gone into the proposal but that he considered it a very big step to take the taxation system out of the democratic process:

> … It is much bigger than taking monetary policy out. Monetary policy does not have the distributional consequences that fiscal policy has, and I think it would be a very big step. Although, I, in

57 Evidence, p 21.

58 Evidence, p 44.

59 Evidence, p 40.

> principle, have no objection to it, I cannot imagine that a democratic society would be able to handle that as comfortably as they can with monetary policy. Because, remember, independent monetary policy is really delegated to us. It can be taken away again if we do not handle it properly.[60]

2.73 On the issue of the Bank delaying payment of almost $700 million of the Government's dividend until next financial year to overcome a possible budget deficit, the Governor said:

> It was already in our annual report. Our shareholders have got the right to receive their dividend whenever they want to receive the dividend. I should remind you that on some earlier occasions governments have actually asked for dividends that that had not even been earned to include in their budget. So we could hardly claim that there is anything wrong with this, which is simply taking receipt of something which has clearly been earned in two separate financial years, rather than in one.[61]

2.74 The Governor added that he felt there is a case for devising a method which would smooth out the Government's profits and avoid the large variations from year to year which complicate fiscal policy. Unfortunately, he said, it is a rather difficult thing to do and the Bank had not yet devised a suitable mechanism.[62]

Household debt

2.75 The Committee expressed concern over recent statistics which indicated a substantial rise in the level of household debt. This referred to comments in the November Semi-Annual Statement, which indicated that the ratio of household debt to the disposable income of households had risen 12 percentage points in two years, to reach 94 per cent.[63]

2.76 The Governor commented:

> … when we talk about household debt, there is a number of ways of measuring it. We have probably been as guilty as others of measuring it in a way which probably makes it look a little more alarmist than it is, because we have looked at the level of

60 Evidence, p 22.

61 Evidence, p 23 and Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, p.65.

62 Evidence, p 23.

63 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999.* RBA, Sydney, p 17.

> household debt, which is a stock, and compared it to a flow, which is household income…[64]

2.77 He added that financial experts would probably use a different method of measurement, such as the stock of debt compared to the stock of assets. This would take into account the recent increases in the value of assets also.

2.78 This was reflected in the November Semi-Annual Statement, which said:

> …Continued strong growth in the household sector's assets … has resulted in the ratio of household liabilities to assets remaining roughly stable for the past few years. The household sector's net worth (assets less liabilities) remains at a high level.[65]

2.79 The Committee sought some additional comment on this issue and indicated that there seemed to be a lack of management strategies for dealing with this problem. The Governor replied:

> We cannot manage household debt. Households are supposed to manage household debt, not central banks. … All we can do with monetary policy is come up with the right policy on average for the country.[66]

Capacity restraints

2.80 The Committee questioned the Governor about the likelihood that the declining unemployment level would lead to capacity constraints within the economy. It referred to comments in the November Semi-Annual Statement which indicated that some skills shortages were already developing and that vacancies for skilled employees were at historically high levels. There was particular interest in determining whether this would induce pressure on wages, push up inflation and consequently influence monetary policy.[67]

2.81 When asked whether it was possible to quantify the extent of capacity constraints and the size of the output gap, the Bank said:

> … there is always capacity for constraints for particular skills. … In a recession maybe there is not, but most of the time there will be

64 Evidence, p 16.

65 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 17.

66 Evidence, p 20.

67 Evidence, p 11 and Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, pp 22-23.

> some skills shortages where there is the usual amount of advertising and people having trouble filling positions and trying to bring in skills from other countries. ...[68]

2.82 The Committee asked whether capacity restraints are now a bigger issue than in the past and the Bank said that they were not. The Governor explained that the modern strategy for restraining inflation was to tighten monetary policy before the capacity constraints were upon you. He said this was designed to avoid periods of excesses or imbalances:

> ...If it works out successfully you will have less periods of clear overheating and excess. The corollary of those periods of overheating and excess, where inflation goes up and where asset prices go up and where you have investment booms where people build far more than they need, is the recessions that follow them. The more you can avoid those periods of excess the more likelihood you will have of having a longer expansion and having periods where the periods of weakness are slowdowns rather than recessions.[69]

2.83 In the February 2000 Reserve Bank Bulletin, however, the Bank noted that survey had indicated that some employers were having difficulty in attracting suitable staff. The Bulletin suggested that while growth in labour costs has been moderate so far, it is likely that there will be pressure on wages over the next year or two.[70]

2.84 The Committee will continue to monitor this issue.

Inflation

2.85 The November Semi-Annual Statement indicated that inflation, while still low, had begun to increase. The Statement showed that the CPI had increased 0.9 per cent in the September quarter, compared to 0.4 per cent in the June quarter. The year-ended inflation rate had also risen to 1.7 per cent or, if the estimated temporary effect of the health insurance rebate is excluded, 2.2 per cent.[71]

2.86 In his opening remarks at the public hearing, the Governor indicated that inflation was expected to stay between 2 and 3 per cent until the middle of 2000. However, he also indicated that: "... the quite lengthy period during

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68 Evidence, p 11.

69 Evidence, p 12.

70 Reserve Bank of Australia. *Bulletin*, February 2000. JS MacMillan, Sydney, p 1.

71 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November, 1999*. RBA, Sydney, p 37.

which inflation was undershooting our target seems to have come to an end. …"[72]

2.87 The main influences on inflation during 1999 were the increase in world oil prices and, acting in the opposite direction, the health insurance rebate. In addition, there was an increase in the underlying or core inflation rate, which is largely independent of oil price levels.[73]

2.88 Given these influences on inflation, plus the impact of the GST introduction, the Committee wanted to know whether the prospect of increasing inflation was a major concern for the Bank over the next year? It also asked how difficult it would become if the effects of these changes failed to dissipate as expected? The Bank replied:

> …You are right that it does make things a bit more difficult than they might otherwise be if you have a rise in inflationary expectations, which we have. It is not unreasonable when we ask people what their inflationary expectation is, and they are looking out for one year, for them to have an increase in that. It is like the price level itself. The big issue is: do they come down again once we get past that once off rise? At the moment we are assuming that they will, but it is something that we will be monitoring very closely.[74]

2.89 The Bank's expectations for the inflation rate included the anticipated impact of the introduction of the GST from July 2000. The Governor said that this was expected to affect price levels but not the ongoing rate of inflation. He did note, however, that this position was based on the assumption that the GST should not affect wages – that the net effect of tax changes should be to increase disposable incomes by more than the expenditure increases. Accordingly, it will be important to ensure that businesses do not raise their prices more than is justified by the net impact of the GST and the changes to indirect taxes.[75]

2.90 The Committee queried whether imperfect knowledge among workers and trade unions will lead to increased wage demands? It was noted that some people think that the net effect of the GST will be an additional ten per cent on price levels, rather than the net two or three per cent as forecast. The Governor responded:

72 Evidence, p 4.
73 Evidence, p 4.
74 Evidence, p 41.
75 Evidence, p 5.

> I do not know that I am particularly worried about it. I am not surprised to hear that some people think that the effect is going to be 10 per cent, because the publicity that has been directed towards the reductions in wholesale sales tax has obviously not been as great as the publicity that is associated with the introduction of the GST. The people who are going to be making the decisions, the union leaders and the businesses, will know that it is not going to be 10 per cent.[76]

2.91 Some forecasters in the private banks have estimated that the initial GST impact on inflation would be 3.5 per cent, rather than the official Treasury forecast of 1.9 per cent. The Committee raised this issue and sought the Bank's opinion on which estimate was the more accurate? The Governor acknowledged that different estimates of the GST impact existed but, he said:

> We have to rely on the Treasury forecast because this is very complicated forecasting procedure. We are not talking about forecasting inflation in general; we are talking about the bit that you add on to your underlying which is caused by applying the GST on all services and most goods and taking off a very complicated structure of wholesale sales taxes. So it is very much a disaggregated exercise in trying to forecast what happens – what the aggregate of all these very different changes is. Treasury have their PRISMOD model which is designed to do that. So our approach has been that, if anyone should be able to do it, they should.[77]

2.92 The Committee referred to the Bank's assumption in the opening statement, that there will be no second or third round wage effects from the GST and that, after initially increasing, the inflation rate will return to approximately current levels. He was asked how strong is the risk that these assumptions will not hold? In answer he said:

> I do not know that I can put a probability on it, but our view is that the main probability is that the assumption will hold… we will be watching it very closely. That will not just be the second round wage effects; we will be watching the price effects too. We are not personally doing it, but we will be very interested in how prices move as we approach that date. We will be very interested in the sorts of findings that the ACCC comes up with.[78]

76 Evidence, p 25.

77 Evidence, p 42.

78 Evidence, p 25.

2.93 In response to a similar question, the Governor reiterated the Bank's expectations on the inflationary impact of the GST:

> Our forecast for underlying inflation is that it stays within the band at about 2½ per cent or so in the year that we are now in. It goes up in the year the GST comes in and then it goes back to 2½ per cent after that. So we do not have a model where we think, at the moment, we are going to have a problem.[79]

2.94 The Governor's comments were sought on an opinion that monetary policy should only be used to counter inflation arising from demand and wage pressures and not when it is caused by unavoidable price increases, such as those arising from a depreciation of the exchange rate. The Governor indicated that the bank had already dealt with this problem:

> One of our judgements over the last two or three years was that, if you have a negative external shock because of a contraction in your export markets and a fall in your commodity prices and that leads to the exchange rate falling but you cannot see it leading to a permanently higher inflation, then you should not counter it with monetary policy, and we did not counter that with monetary policy. So we have already really been put to the test on that proposition, and we have given our answer.[80]

Business investment

2.95 The Committee referred to the rapid decline in business investment in 1998; a period the Governor had described as a 'flat spot'. His comments were sought on that issue and also on whether there were any signs of a recovery in investment? The Governor said that he was not displeased at the slowdown in investment, because at this stage of the expansion there is a risk of creating over capacity:

> Business investment has flattened out and it flattened out really towards the middle of 1998. Some people are very disappointed in that, but I am not. If you look over the whole expansion that we have been through, business investment has grown very strongly.
>
> … that we have had a pause in this big investment expansion I do not think has been any bad thing at all …[81]

79 Evidence, p 41.
80 Evidence, pp 41-42.
81 Evidence, pp 26-27.

2.96 Looking ahead, the Governor suggested that the likelihood was for small positive growth of about 2 or 3 per cent. He concluded by saying:

> …So we have had plenty of investment in this expansion, and it was just a matter of time, I think, before it flattened out, and that is what is happening now.[82]

82 Evidence, p 27.

3

Financial System Stability

Year 2000

3.1 In its most recent Annual Report, the Bank reported that its systems, services, processes and facilities were all ready for the Year 2000 changeover. It said that normal banking services would be offered to customers over the New Year.[1]

3.2 At the June 1999 hearing before the Committee, the Governor indicated that Australia's financial system was well prepared for Y2K, although not all of the final testing had been completed at that time. At the November hearing he was able to add:

> … They had not completed all their final testing at that stage but now they have, and everything is being done to make sure that their computer systems will be able to handle the change to the new century.[2]

3.3 He remarked also that:

> New Years Eve is going to be a rather unusual one this year in that a lot of people will not be out enjoying the festivities but will be at work to make sure nothing goes wrong. At the Reserve Bank we will have a team in place, including myself, and a communications centre to receive up-to-date information from financial institutions on what is happening. This centre will be linked to the Commonwealth Government's national coordination centre in Canberra and to various international networks that have been established.

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1 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, p 37.

2 Evidence, p 6.

> … I am confident that Australia will acquit itself well, once again, in the eyes of the world when the great day comes. …[3]

3.4 When asked whether our Asian neighbours were as well prepared for Y2K as Australia, the Governor responded:

> … in terms of how we make the transition on the night, I do not think the weaknesses in other countries are going to have any impact on us at all, …[4]

3.5 The preparations proved to be successful because at 2am on 1 January 2000, the Governor of the Reserve Bank was able to say in a Media Release:

> I am pleased to say that, at this early stage, all indications are that the Australian financial system has made a smooth transition to the Year 2000.
>
> Over 50 banks, building societies and credit unions have already reported in to us; together, these institutions account for over 90 per cent of ATM, EFTPOS and credit card transactions in Australia. They report no problems to this point. …[5]

3.6 After explaining some of the continuing precautions being followed by the financial system, the Governor concluded:

> Finally, may I say how pleased I have been with the way that Australia's financial institutions and their customers have approached the Year 2000 issue. Financial institutions have prepared thoroughly for the date change and have gone to considerable effort to reassure their customers about the safety of their deposits and the integrity of their records. For their part, customers have taken a responsible and level-headed approach in the lead up to the Year 2000. I am confident that they will continue to do so in the days ahead.[6]

3.7 A survey of the past year's activity in the Reserve Bank Bulletin for February 2000, confirmed the success of the financial system's transition to the year 2000; it commented that the changeover took place "without incident".[7]

3.8 The Committee is pleased with this positive outcome. It congratulates the Bank for the significant role it played in preparing the Australian

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3 Evidence, p 6.

4 Evidence, p 13.

5 Reserve Bank of Australia. *The Year 2000*, Media Release, 1 January 2000. RBA, Sydney, p 1.

6 Reserve Bank of Australia. *The Year 2000*, Media Release, 1 January 2000. RBA, Sydney, p 1.

7 Reserve Bank of Australia. *Bulletin*, February 2000. JS MacMillan, Sydney, p 2.

monetary system to deal with the problem and in keeping the issue in clear perspective for the Australian public.

Surveillance of the financial system

3.9 In its Annual Report, the Bank outlined its view of the necessary foundation for a stable financial system:

> Financial stability is built on a number of foundations. The first is a low-inflation environment. Such an environment reduces distortions in the financial sector and discourages asset speculation financed by borrowings. … However, low inflation itself does not guarantee financial stability … Excessive credit growth and asset-price bubbles can still occur, putting at risk the financial system and the performance of the economy more broadly.
>
> A second foundation is a safe and robust payments system – one in which difficulties in a single financial institution do not cascade through the financial system. Reflecting this the Reserve Bank has been given formal responsibility for the safety and efficiency of the Australian payments system, a responsibility exercised by the Payments System Board. Australia's real-time gross settlement (RTGS) system, which has now successfully completed its first full year of operation, plays a vital role in this regard by eliminating settlement risk for those high-value payments between financial institutions which are at the core of the payments system.
>
> A third foundation for financial stability is efficient and smoothly functioning financial markets. As recent events in Asia and elsewhere have confirmed, financial instability arising from disturbances in financial markets can be as costly as instability caused by financial institutions in distress. The Reserve Bank closely monitors developments in, and the integrity of, the major financial markets – which are essential to the conduct of monetary policy and relevant for financial stability more generally…[8]

3.10 In examining the effectiveness if the Australian financial system, the Bank noted that in 1998-99 the system faced a number of tests which, together, might have led to pressures on financial stability – e.g. economic and financial problems in Asia, the turmoil in financial markets caused by Russia's moratorium on foreign debt repayments and the near collapse of

8 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, pp 26-27.

the hedge fund Long-Term Capital Management. The Bank assessed the outcome as follows:

> …The Australian financial system has coped well with these developments and remains in strong condition, underpinned by the robust growth of the Australian economy.[9]

Current account deficit

3.11 The Committee expressed concern that the CAD could remain above 6 per cent of GDP for some time. It sought an estimate of how long it would be before it could be brought down? The Governor explained that normally when the CAD reaches that level, the economy is growing very rapidly and that growth is followed by a sharp slowdown or recession – which rapidly turns the CAD around. The circumstances this time are different, he said:

> … We are foreseeing the current account improving, not because we are going to slow down sharply but because the rest of the world is picking up and I think that is happening more gradually. I really am just trying to say that there is a different profile this time. If we looked at it as a mountain, it would not be a sharp peak; it would be a sort of rounded one.[10]

3.12 Referring to the November Semi-Annual Statement, the Committee suggested that the Bank had an underlying concern about an emerging gap between consumption and output. If that gap produced substantial imbalance, the Committee said, it could push the CAD to a problematic level. It sought the Governor's opinion on that issue and he answered:

> We are not pessimists on the current account. … Everything that has happened so far in the current account would have to make you an optimist. To have such a huge disparity between our growth rate and that of our trading partners and to have falls in commodity prices, and for it still to take so long for the current account to get up to six per cent, has got to be a good sign for the future.[11]

Derivatives

3.13 The Committee brought to the Governor's attention, comments in the press about the Treasury dealing in derivatives to try to lower the cost of borrowing. The Committee asked whether the Treasury had the necessary

9 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, p 30.

10 Evidence, p 38.

11 Evidence, p 39.

skills and expertise to be involved in that area and whether doing so involved some risk?

3.14 The Governor said in reply that you first need to determine what sort of derivatives are being discussed. He gave some examples of the RBA's own dealings with derivatives:

> … If we hold a lot of assets in some particular currency and we like the assets but we do not like the currency, we will take an offsetting forward position in that currency to reduce our exposure to that currency. We also deal in futures markets which are derivatives.[12]

3.15 The Bank's annual report gave a further example of the techniques used to assist in stabilising the Australian currency:

> …Instead of relying simply on outright purchases of the currency, as it had done in the past, the Bank also purchased call options on the Australian dollar …[13]

3.16 When prompted again by the Committee to comment on the Treasury's qualifications to deal with derivatives trading, he said:

> I can only assume that Treasury do understand the nature of what they are doing. My casual observation of it is that they do and have chosen to enter the swap market to slightly change the currency component of their debt. I do not have an in principle objection to things like that as long as there is very good understanding of the risks and very good governance. It is absolutely crucial that people at the highest level in the institution know exactly what the institution is doing rather than have traders taking decisions that other people are not aware of. I am sure that Treasury can pass all those standards.[14]

12 Evidence, p 40.

13 Reserve Bank of Australia. *Report and Financial Statements, 3 August 1999.* RBA, Sydney, p 14.

14 Evidence, p 40.

4

Other Issues

Small business bank fees

4.1 The Bank presented the Committee with a paper which examined the impact of bank fees on small businesses. The Bank had agreed to carry out this work at the last hearing.[1]

4.2 The conclusions drawn by the Bank were:

- there has not been a systematic increase in fees charged; in some cases (larger loans) fees seem to have fallen;
- account servicing fees have fallen a little and the number of fee-free transactions has increased;
- fees for transactions have increased for high-cost transactions (e.g. cheques) and where older technology or other banks' ATMs are used. Fees for own-bank ATMs have been steady and fees for newer services have fallen;
- total fee income increased by 15 per cent in 1998. The increase, however, is in line with increasing transaction levels and the 'per unit' cost does not seem to have increased; and
- it is unlikely that the increase in fees charged to small business has offset the benefits received when interest margins fell.

4.3 The Committee thanked the Bank for carrying out this research and noted that bank fees to small business seemed to be increasing faster than fees to big business. Was this of concern to the Bank? The Bank observed that their data covered only two years, 1997 and 1998, and suggested that the

1 House of Representatives Standing Committee on Economics, Finance and Public Administration. *Review of the Reserve Bank of Australia Annual Report 1997-98*, 1999. CanPrint, Canberra, p 39.

Committee should not read too much into figures for such a short period, then added:

> …Fees to households have risen faster than small business which has risen faster than big business. I do not know that I would necessarily be concerned about that. … banks have always charged fees to business – they did not charge fees to households. But businesses, whether it was large or small businesses, always were used to paying fees to banks…
>
> It would not surprise me with businesses if small businesses paid smaller fees a long time ago than large businesses, so there is an element of catch up there. Or the other possibility is large businesses have got huge turnover, so the fees per unit are smaller than they are for small businesses. But I do not know that I could read too much into that. It is only two years…
>
> I do not think the fee issue is as sensitive for business as it is for households because, as I said, households went from paying no fees to paying fees, whereas businesses were always paying fees.[2]

4.4 The Committee queried whether the Bank had looked at the profits of the four major banks and whether there was enough pressure on them to compete through lower charges and fees. The Governor said that the Bank had looked at this question for all banks, not only the majors:

> …You will remember one of the pieces of work we did last time was whether they are maintaining their profits either by holding up their margins … or by putting up fees. We concluded on the first point that that margin … has been whittled away, that their customers have gained, … there was enough competition in the finance sector in Australia to whittle down those margins. Some of us thought that maybe bank profits would go down. They did not go down, really, by and large. Mind you, this is the phase of the cycle where banks' profits are at their maximum.
>
> Was it because they were putting up fees to offset the reduction in margins? We did that study and we discovered that the increase in fees was very small compared to the reduction in margins. So how have they remained profitable? They have remained profitable because they have cut their costs. … we are finding the same sort of result here as people find in other countries, that banks have been able to remain profitable by massive cuts in costs.[3]

2 Evidence, pp 27-28.

3 Evidence, pp 28-29.

4.5 The 1999 data on small business bank fees will be of interest to the Committee when they become available and it will continue to monitor the changes to bank fees to small business.

4.6 The Committee remains concerned about bank profitability, fees and charges, suggestions that shareholders are favoured over customers and bank closures. These issues will also remain under consideration.

Credit cards and bonus schemes

4.7 The Committee noted that credit card debt has increased dramatically and asked whether this was influenced by the availability of bonuses, frequent-flyer points and similar loyalty rewards? The Governor agreed that rewards were a factor and said:

> …We think that, certainly, there is a huge increase in transactions using credit cards as people seek to get their bonus points. …[4]

4.8 Pursuing this line, the Committee wanted to know if those using such schemes might be getting a benefit that other consumers do not get? The Governor said:

> What you are saying is somewhere someone has got to pay for those bonus points. …
>
> … Somewhere in the community some prices are reflecting that so that that value can be transferred across to the people who earn the bonus points. Yes, that is true. … Is paying by credit card the most efficient way of paying, or is it simply being done because people get their points? In some cases there are more efficient and cheaper ways of paying for the economy as a whole.[5]

He added that the Payments System Board has commenced a study on this question.[6]

4.9 The Committee were interested in the Bank's opinion on whether the banks had educated their customers sufficiently on the costs of various banking products and the possibility of hidden costs in the use of some of them. The Governor replied:

> There is a lack of community understanding on these issues. In fact, we do not fully understand all the subsidies and cross-subsidies that are involved. That is why we are undertaking this study of what are called interchange fees. … There is a complex

4 Evidence, p 29.

5 Evidence, p 29.

6 Evidence, p 29.

> web of transactions that go on underneath the surface and there is not a very wide knowledge of it in Australia. … The belief which a lot of people have that somehow or other these loyalty points or these frequent flyer things come from the generosity of someone or they come from nowhere is obviously not correct.
>
> Obviously, someone, somewhere along that chain of value, is paying a lot of money for something and the recipient is giving away some of it as a discount in the form of the loyalty points. … The only sign of community unrest is that a number of merchants feel that they have to pay merchant fees that are too high for access to credit cards, EFTPOS or whatever it is. … Consumers as a whole I do not think have indicated any great worries. ...[7]

4.10 The Committee suggested that other issues came into play, such as relationship marketing and intangibles which cannot always be measured, to account for the growth in credit card use. It noted also that the administration of loyalty schemes is a clear cost, which must be passed on somewhere. The Governor agreed:

> Yes, it is a cost – and the cost is no doubt embedded in the price of the goods for which you are paying. If you pay for something with an expensive payment mechanism, then that has got to show up somewhere. Ultimately, the goods you are buying are going to be a bit more expensive than if you buy something with an inexpensive payment technique. The simplest example of that is the discount for cash. Somewhere in the prices of all the goods you buy is a component which reflects the cost of the payment technique that is being used to buy them.[8]

4.11 There was a discussion of consumer behaviour, in which the Committee sought an explanation of why consumers would act in ways which, at times, disadvantaged themselves financially – simply to get frequent flyer points. The Governor found it difficult to explain why consumers would act in ways contrary to their own interest, but observed:

> …I think that many of these loyalty programs are designed to get people to change their behaviour, do things that they probably would not otherwise do if they were not there and, in extreme cases change their behaviour,… in such a way as to actually harm themselves.
>
> …The consumer has a positive incentive to use the credit card as much as possible because, if they are building loyalty points, it is

7 Evidence, p 32.

8 Evidence, p 32.

> actually not costing them at all. There is a small gain to them. We say it is a negative cost … What we are trying to understand is who, in the end, is paying for the higher cost of that instrument and the associated loyalty rewards.[9]

4.12 The Committee will review the results of the PSB's study on these issues when it becomes available. The Committee will also be interested to examine the results of the Board's study on interchange fees which was mentioned in its Annual Report.[10]

Payments system board

4.13 The Committee questioned the Bank about the most efficient forms of payment and why direct debit, probably the most efficient method of all, has not gained wide acceptance in Australia? The Assistant Governor (Financial System), Dr Laker, explained at some length why this was so and what remedial action the Bank had in mind:

> That difference between our payments patterns and countries overseas became quite stark to the board when we started looking at how our country compared. … Other countries use direct debits quite frequently, and that usage has been going up over time. We are in the unusual position where usage is quite low and it has actually been falling over time. So in that area we are in stark contrast to other countries.
>
> … the Australian community at this stage has not learnt to love the direct debit. That is a cultural difference between us and other countries where the direct debit is very well established. Other countries have made an effort to make that instrument more attractive. They provide different kinds of consumer safeguards either in the form of guaranteed refunds or in trying to synchronise the direct debit to the payment of salaries. We have not tried those safeguards.
>
> We are talking to billing organisations to see if it is possible to get a direct debit package together that will be more attractive to consumers because what is very clear is that it is by far and away the most efficient way of paying routine bills. … We are trying to get what we would call a statement of best practice for billers to offer to their customers.[11]

9 Evidence, pp 32-33.

10 Evidence, pp 32-33.

11 Evidence, p 30.

4.14 The Committee sought clarification on whether the financial sector as a whole was examining this question or whether it was something of interest to the RBA and PSB only? The Assistant Governor (Financial System) responded:

> The most immediate savings in bill payments go to the billers. It is becoming quite clear to them that some of the payments options are expensive on their bottom line so they have an incentive to try and make that process as cost effective as possible. … It is for them to take this further, … It has to be a collaborative effort but the incentive in the first instance is to save costs and make our payment system more efficient.[12]

4.15 The Committee thought that the lack of interest in promoting direct debit might be due to the banks making just as good a profit out of the existing systems, even if they do happen to be more expensive overall? The Assistant Governor (Financial System) considered that it seemed to have more to do with customer attitudes and a lack of consumer confidence in the direct debit system:

> I think at the end of the day the customer needs to be confident about how they pay their bills and confident they have some control over the timing of their payments for fear that they might be in dispute or subject to some sort of rogue bill that was clearly a computer mistake. For reasons that we are still learning, the Australian customer has not been as attracted to a direct debit, an automatic process, as other customers and that in part reflects the history of the scheme. … It is not part of our way of life.
>
> One possible way of getting people to shift is if the billers gave them a discount for using a cheaper form of payment and direct debit is the cheapest form. Maybe the market might move in that direction at some stage.[13]

4.16 The Committee will monitor developments on direct billing and will examine the PSB report when it is available.

4.17 Moving on to a related topic, the Committee queried whether facilities will be made available for deposits to be made through the EFTPOS system and whether the PSB had this idea under consideration? The Governor said:

> …It is not a matter that has come to the Payments System Board as such. We have really been looking, not so much at the retail end of

12 Evidence, p 30.

13 Evidence, pp 30-31.

> making deposits and withdrawals at this stage, but more at the actual linkages in the payments system itself…
>
> I am not sure it is a payments system matter. … It is pure banking. That is really deposit taking. … It would seem to me it would be an issue of whether that particular merchant has got the facilities to store possibly large sums of money on their premises. The linkage is there. You can get a credit to your account through an EFTPOS machine at the moment.[14]

4.18 The Committee will raise this matter with APRA.

4.19 The Committee referred to a comment in the PSB Annual Report which reported that some major banks had not yet met the three-day cheque clearing standard. The Committee asked whether any progress had been made on the issue? The Assistant Governor (Financial System) noted that since the Annual Report was released, Colonial State Bank had been added to the list of banks reaching that standard. He also added that:

> … We will be back in touch with the banks that are not on that list through the course of the next year or so to see what progress they are making on reaching that standard. In our annual report we will draw attention to the choices that are available for Australian consumers between banks that offer that three-day cycle and those that, for whatever reason, do not. But we will work with the remaining banks to understand what it is that makes it difficult to get to that target.[15]

4.20 This issue will be raised again at the hearing in May.

Public accountability

4.21 The Committee noted that the RBA has a good record of public accountability. During the hearing there was some discussion about two examples of statements attributed to the Governor in the press.[16]

4.22 The Governor commented on the general arrangements for public scrutiny of the Bank's operations:

> This hearing itself is a very important part. The fact that we have this twice a year, the fact that we produce this document for it, are very important parts of it. In addition to that, we also produce a document in the other quarters that are not covered by this one. I make public speeches and some of my colleagues, like those sitting

14 Evidence, p 31.

15 Evidence, p 44.

16 Evidence, pp 32-33.

> on either side of me today, make public speeches and we have a list of articles and notes that we publish in our monthly bulletin. So I think we have extensive communication with the public and with the financial markets which add all those particular channels together. …[17]

4.23 However, he reiterated comments made elsewhere that in the future he would not be undertaking private briefings or speeches. He had taken this approach because his remarks at those meetings always managed to find their way into the newspapers.[18]

David Hawker MP,

Chairman

7 March 2000

17 Evidence, p 43.

18 Evidence, pp 42-43.

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.

B

Appendix B - List of hearings, briefings and witnesses

Public Hearing

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, 30 September 1999 – Canberra

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

Monday, 22 November 1999 – Canberra

Mr Peter Osborne, Chief Economist, Merrill Lynch

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