HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia's annual report 1996-97

SYDNEY

Thursday, 6 November 1997

OFFICIAL HANSARD REPORT

CANBERRA

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Members

Mr Hawker (Chair)

Mr Albanese	Mr Mutch
Mr Anthony	Dr Nelson
Mr Causley	Mr Pyne
Mrs Gallus	Dr Southcott
Mr Hockey	Mr Willis
Mr Latham	Mr Wilton
Mr McMullan	

Matter referred to the committee for inquiry into and report on:

Reserve Bank of Australia's annual report for 1996-97.

WITNESSES

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reserve Bank of Australia's annual report 1996-97

SYDNEY

Thursday, 6 November 1997

Present

Mr Hawker (Chair)

Mr Albanese	Mr McMullan
Mr Anthony	Dr Nelson
Mr Causley	Mr Pyne
Mrs Gallus	Dr Southcott
Mr Hockey	Mr Willis
Mr Latham	Mr Wilton

The committee met at 10.34 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this public hearing of the House of Representatives Standing Committee on Financial Institutions and Public Administration. At the end of this hearing there will be a short press conference to announce another inquiry that the committee will be undertaking which will look at the provision of banking and similar services in regional Australia. I think that could be a very interesting inquiry and the committee is very keen to undertake it.

On the public record, I would also like to thank Bob McMullan. I think this will be his last public appearance with the committee. Thank you for all your help, Bob.

The main purpose of today's hearing is for the governor to report on the conduct of monetary policy. The hearing is being conducted as part of the committee's review of the Reserve Bank of Australia's 1996-97 annual report. In addition to monetary policy, the committee will also examine a number of matters relating to the bank's supervisory responsibilities. This is the second appearance by the governor to report on monetary policy. The committee welcomes this opportunity to contribute to making the conduct of monetary policy a more transparent process. I believe these hearings have greatly assisted the parliament and the community to improve their understanding of monetary policy and their appreciation of the role of the Reserve Bank.

A lot has happened since we last met. The government has responded to the Wallis report and we have seen a great deal of turmoil in the financial markets. We have also seen two cuts to official interest rates. All of these issues will be canvassed today. The committee has had an opportunity to read the *Semi-annual statement on monetary policy*.

[10.37 a.m.]

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales

THOMPSON, Mr Graeme John, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales

CHAIR—I welcome the representatives from the Reserve Bank to today's public hearing. I remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament. Mr Macfarlane, I understand that you wish to make an opening statement before we proceed to questions.

Mr Macfarlane—That is correct, Mr Chairman. I will continue with that tradition. Thank you very much for your introduction. It is a pleasure to be here in front of your committee for the second time under the new arrangements set out in the statement on the conduct of monetary policy. On the basis of the first hearing, we think the new arrangements are working very well. On that occasion we received some very penetrating and constructive questioning from committee members. There seemed to be quite a bit of public interest in the proceedings.

Of course, we should always be trying to improve our procedures. The only improvement we have been able to make on this occasion is to get our half-yearly report to the committee two hours ahead of the hearing compared with one hour last time. You will appreciate that, in order to follow due process, we really cannot finalise the document until after we have had our board meeting. Our board meeting was only held last Tuesday. We are running to quite a fine timetable. The whole thing had to be printed between Tuesday and now.

I should also say that I was hoping that we would be able to have this hearing somewhere other than Sydney. It is very convenient for my colleagues and me to be able to meet again in the New South Wales parliament house, which is only about 100 metres from our offices, but we see merit in moving to other state capitals, if that is possible, or to Canberra.

CHAIR—We were all ready to go to Melbourne but unfortunately accommodation in Melbourne is a bit tight this week.

Mr Macfarlane—I see. We were frozen out by the horse racing, were we? I see.

The main reason for these hearings is to improve the accountability of the Reserve Bank, both directly to parliament and via the press coverage to the public more generally. In the spirit of increased accountability I should, I suppose, be accountable for what I said to this committee at the previous hearing as well as for what I am going to say today.

I covered a number of subjects at the previous hearing which I thought were important for an understanding of how the economy was going to perform over coming years. I also mentioned a couple of outcomes we expected for 1997. It is those which will probably be of most immediate interest. I said that after a sluggish 1996 where GDP had grown at about three per cent—at one point it got down to not much more than 2½ per cent on a 12-months ended basis—we should expect it to pick up to about four per cent in 1997. I also said that I expected inflation to stay at the bottom of the two to three per cent range with the possibility that it could go a little lower for a while.

I think I could be excused for wanting to walk away from earlier forecasts as a result of the current turmoil in Asia and the world financial markets. I intend to say a lot about those events later on, but I do not want to invoke that excuse at this stage because those events, as you would imagine, have really not had any effect on the economy to date; they have affected financial markets but it is too early for them to have affected the economy. I want to start by saying that in our view the baseline that we have to work from—for instance, the growth in the economy in the first three-quarters of 1997—has been at least as good as I was pointing to in May, if not a little better.

We now have GDP growth rates for the first two quarters of 1997 which showed the economy grew at an annual rate of nearly four per cent during that time. We have further monthly figures for the September quarter which are somewhat stronger than those recorded in the first half of the year. This is true for the major monthly indicators such as retail trade, imports and exports. It is also true for the labour market, especially for vacancies but also to some extent for employment. There is also some evidence from the business surveys that confidence is rising, although of course these surveys were generally compiled before the headlines about Asia of the recent fortnight.

The outlook on inflation has changed a little. The new figures brought underlying inflation to below two per cent and our ongoing assessment caused us to lower our forecasts. As a result we have had two further easings of monetary policy—as the chairman reminded us—one in May and one in July. An important reason for the lower inflation forecasts was the better outlook for wages. You may recall that shortly after the previous hearing in May we received revised figures on wages and earnings from the Bureau of Statistics that suggested that not only were they lower than we had formerly thought, or had been formerly published for the March quarter of 1997, but that an apparent upward trend had been revised away.

This better picture was confirmed again in the June quarter figures, but the picture has been muddied somewhat by recent September quarter figures which show an unexpectedly strong rise. Basically, for most of the intervening period between the last hearing and this hearing we received quite good figures on wages. We started to receive them shortly after the committee meeting.

On balance, therefore, we at the bank judged that the information becoming available over the past six months was tending to confirm this relatively benign view of the future: GDP growth of about four per cent, which is enough for some further reduction in unemployment from the 8.8 per cent rate we had at the time of the last meeting in May, and inflation a little below two per cent, which was enough to justify the May and the July easings in monetary policy.

The picture was not all rosy. The slower output growth in 1996 was still making its presence felt in the form of sluggish employment growth in the first half of 1997. There were some doubts about the strength of investment, and the effects of El Nino were around the corner. But economies nearly always show a mixed picture and this mixture was better than most.

In addition, financial conditions had clearly become easier since May. The overnight cash rate had come down from six per cent to its present level of five per cent as a result of the two easings in monetary policy. Yields on 10-year government bonds were down from 7.75 per cent in May to the six per cent they are at present. The exchange rate against the US dollar has come down from 77.7c to its present level of about 70.3c. Of course, it has come down a lot less in trade-weighted terms. In trade-weighted terms it has come down from 60.2 to the present level of 57.

I suppose it is time for me to say a few things about what has been happening in Asia and the rest of the world. I will do my best to be specific but you will realise that the ground is constantly changing under our feet. You would have got a very different report two weeks ago and a different one if I had been here a month before that.

The first thing I want to say is that in the long run I am still very optimistic about Asian growth prospects. Those countries still retain a set of characteristics that are conducive to long run growth. The first characteristic is that they can still achieve rapid productivity growth through technology transfer because they have started a long way behind the frontier and they have a long way to go. World Bank figures suggest that GDP per head in Australia—I think this is in 1995—was $19,000, in Malaysia it was $9,000, in Thailand it is $7,000, in Indonesia $4,000 and in the Philippines $3,000. They have still got, in the long run, a lot of room for catch-up or convergence, which has been a very important factor in explaining relative growth rates. That is not the only factor but it has been a very important one.

They are oriented towards international trade. They have very high savings rates and high investment and relatively small government sectors. They have had generally sound fiscal and monetary policies, and they still do, although they have got some way to go in terms of the soundness of their banking and financial sectors, and they have great respect for and devote considerable effort to education.

I do not see the end of the Asian miracle, but that is partly because I do not think it ever was a miracle. I think it was just the application of some tried and tested rules of good economic policy for growth. I think it is still fortunate for our long run prosperity that we are in this region.

Having declared my optimism about the long run, I should now turn to the short run. Clearly, there are going to be difficulties here, particularly among the four ASEAN countries—Thailand, Malaysia, Indonesia and the Philippines. From the moment the Thai baht was floated on 2 July, the tension quickly broadened to encompass all four of these economies. Their currencies have all fallen sharply, as have their stock markets and probably their property prices. The countries are now battening down the hatches, in two cases with the help of the IMF and multilateral packages of which Australia is a member. They are battening down the hatches to try and sort out their problems.

After the dust has settled, their principal problem is how they are going to handle this fall of previously over-inflated asset prices, which were partly due to some undisciplined lending by local banks and foreigners, and some very opaque interrelationships between business and government which have obscured the true financial position of a lot of companies and banks.

There also appears to have been over-investment in some areas. As usual, property played a major role in this, but on this occasion there were also some more contemporary avenues, particularly in the electronics area, such as semiconductors, where there is clearly over-capacity and intense competition with falling prices in those four countries, along with Korea and Taiwan.

Of course, the sorts of problems I have just listed have been around for years; they did not just start on 2 July. But they tended to be ignored and glossed over. Now people have become very conscious of them. A part of this adjustment will inevitably involve a sharp curtailment of growth in the short run and a contraction of credit. Imports will fall and so the effects will be spread over other countries. The good news for Australia is that these four countries, that are central to this, account for only 10 per cent of our exports.

If the difficulties were to remain confined to these four countries, the effect on Australia's exports and our growth would be modest. The rest of Asia is, in fact, a lot more important to Australia. Japan is still our largest market. It has been limping along at an annual average growth rate of about one per cent per annum for five years. Our exports to Japan have virtually not increased at all during that period.

The other big Asian markets for Australia are Korea, China, Taiwan and Hong Kong. These are collectively much more important than the ASEAN four—more than twice as important. Some of the underlying problems that afflict the ASEAN four also apply, although more modestly, to some of these countries. For a time it looked as though the ASEAN problems would spill over to these in a big way. That seems less likely now, but we should not speak too soon. I think we should build in an assumption of some slowing in aggregate for these countries.

To judge the effect on Australia, we should in principle have a view on how each country will fare in regard to its economic growth, its imports, its exports and the health of its banking sector. We should also look outside Asia. We have to remember most of the world is outside Asia. It is never easy and sure bets turn out to be wrong. For example, virtually everyone thought the simultaneous share market crash of 1987 and associated company failures would presage at least a slowdown, if not a recession. We all know that, in the event, 1988 turned out to be a boom year for the OECD economy and for Australia.

For the sake of forecasting, let us hope we are a little closer to the mark this time. Most analysis to date has consisted of relatively mechanical application of some assumed lower growth and lower imports among the ASEAN four to lower exports and lower Australian GDP growth. The orders of magnitude, if you just confine yourself to the ASEAN four, are quite small. The most commonly cited figure for GDP growth in Australia is a reduction of about a quarter of a percentage point.

According to press reports, the OECD has recently suggested figures of 0.3 per cent for Australia in 1997 and 0.4 per cent in 1998—that is reductions in the growth rate, not the level. Quite how they got an effect to occur in 1997, when this year is almost finished, I do not know. As I said, I am only relying on newspaper reports. They may not be correct. Those sorts of figures that have been quoted—0.25, 0.3 and 0.4—can become larger if we also bring in lower growth rates for Korea and China. Some people are also looking at Japan again very suspiciously.

We are really getting into the realms of speculation. There is absolutely no hard evidence there at all. The only guide we have will be that this is not the first time that this has happened. In 1984 and 1985, we saw a big drop in ASEAN currencies and in their growth rates. It had the predicted effect. Our exports to Asia for a time were quite weak. This is not generally quoted, but last calendar year there was zero growth of imports in the ASEAN four. Our exports did not go down to zero, but they did slow to those countries. I think we are in a for a period of weakness again. Frustrating as this instability may be, it seems to be an inevitable part of an open competitive economic system, which is the only type capable of achieving strong growth in the long run.

So far I have only talked about Asia, but the outcome for the world economy will depend on more than Asia. We have to bring in two other regions which are both much bigger than Asia—North America and Europe. North America—mainly the United States but also including Canada and Mexico—is growing quite strongly. The recent disturbances in financial markets which were imported into North America from Asia do not seem to have had a lasting impact. If anything, their main effect seems to have been to hose down some overheated asset markets slightly and hence to reduce the likelihood of an imminent tightening of US monetary policy. Such a tightening in the next six months cannot be ruled out altogether, of course.

Europe is finally recording some good gains in economic growth after a disappointingly slow recovery from the early 1990s recession. In fact, European growth has picked up to the point where six European central banks recently tightened monetary policy slightly to head off possible inflationary pressures down the track. When I refer to Europe here I am referring to continental Europe. You will be aware that the UK has been growing quite strongly and has been tightening monetary policy now for over a year.

So far I have talked about Asia and world economic events as though their only effect on Australia was via our exports. Of course, that is only part of the story. The other important part that we have to face is the possibility of further instability in financial markets. For better or worse, as a result of knowledge or through fear, the international investment community is taking a more sceptical look at things Asian—and that includes all countries in the Asian region, including Australia. That means they have become more risk averse and more likely to judge countries and their policies harshly. We have already seen some of the effects on the Asian countries: falling exchange rates, falling share prices, rising risk margins in interest rates and downgrades by rating agencies, usually well after the damage has been done.

We are in a much better position to handle this financial instability than we have been at any stage, I think, in the last quarter of a century. We formerly had a reputation as a boom-bust economy, and investors used to build in quite a large premium for risk when holding Australian assets. We have come a long way in convincing investors that this is a thing of the past. A good example of this is that our bond yields are now only slightly above US bond yields—only 10 basis points above US bond yields—whereas five, 10 or 15 years ago it was not uncommon for the gap to be as high as five percentage points, in other words, 500 basis points. In fact, you can look at graphs and see our bond yields being 700 basis points higher than US bond yields. Now, they have come down and the cost of borrowing for the Australian government or Australian corporates, in the 10-year area, is much the same as it is for the US government or US corporates. So that is a significant reduction in what they term their cost of capital.

Another example is that the Australian dollar used to be one of the most volatile currencies in the world, whereas in the 1990s it has been no more volatile, in fact less volatile, than the major currencies, such as the US dollar, the yen or the deutschmark. Over the past four or five months this has served us well. While the Australian dollar has gone down a fair amount against the US dollar—I quoted the figure before: down from 77 to 70—it remained relatively steady in trade weighted terms. In fact, it was virtually completely steady, in trade-weighted terms, until the last fortnight or three weeks, when the Asian events started making the headlines in the papers every day, and over that time the Australian dollar has declined in trade-weighted terms. But it has done it in a very orderly fashion and it is not an unreasonable market response, given that our export markets have potentially weakened.

This newfound reputation for stability may surprise some people because there is still a tendency to read so much into the small month-by-month or quarter-by-quarter variation in economic statistics. But if we take a longer sweep we can see how many of the economic problems that used to concern us have now been eliminated or are at least under some reasonable sort of control. The headlines are no longer full of stories about the current account deficit or the level of foreign debt; the budget deficit is small; high inflation and its inevitable twin, high interest rates, no longer fill the pages. This does not mean, of course, that we have solved all our economic problems; but we have clearly narrowed them down.

This has also tended to concentrate minds on the one economic problem that clearly remains, namely, the level of unemployment. This is a reasonable priority because less progress has been achieved on unemployment than on the other imbalances in the economy that came to the fore in the mid-1970s and persisted through the 1980s. It is not as though no progress has been made. The unemployment rate has come down from a peak of 11.2 per cent to its present 8.6 per cent. But it has been disappointing progress and has apparently gone unnoticed in the community. A recent survey disclosed that the majority of people think unemployment is higher than it was five years ago, whereas in fact, as I just quoted the figures, it has come down from 11.2 to 8.6.

With six years of the expansion now behind us, at an average growth rate of 3.6 per cent per annum, which is the third highest in the OECD area, we could have hoped for more. You will want to know who the two are who beat us. They are Ireland and Norway, both very small economies—together they are less than half the size of Australia. I think some further progress can be made over the next year, although we will have to accept that it will probably be slow, and monetary policy will only be part of the story—in the long run, only a small part.

Australia moved from two per cent unemployment to 10 per cent in the decade from 1973 to 1983. The damage was really done during that period. Despite good output and employment growth for much of the 1980s expansion, the unemployment rate fell but then was back to 11 per cent following the 1990 recession. So, in net terms, no progress was made in a decade. What we want to do this time is to have good growth in output and employment, with a difference: we want it to last a lot longer. The 6½ years that the two previous economic expansions lasted was not good enough. Although progress was made in reducing unemployment, particularly in the second expansion, it was all lost in the ensuing recession. This time around, we must make sure that we have a much longer expansion, reducing the likelihood and severity of any future slowdown as much as possible.

I do not know whether it will be possible to reduce any future slowdown, but the surest way of ameliorating the business cycle in this way is to avoid the imbalances occurring during the later stages of the expansion. The main imbalance in Australia, as elsewhere, has always been the emergence of inflation. The story is never exactly the same—inflation can be accompanied by a wage push, as it was on some occasions, an asset price boom, or an external imbalance—but the result has always been the same following each of the past three expansions. That is why we need to have a more medium-term focus on our monetary policy and why the inflation target is such a central part of it. The inflation target is not anti-growth. Low inflation is not an end in itself. We are interested in sustaining a good inflation performance because we are interested in growth and employment.

It has sometimes been said that we are too cautious in following this policy. I think that is a little unfair. Of course we are cautious in that we like to look at a range of information and think carefully before we make a move on monetary policy, but we try to be forward-looking and pre-emptive. For example, we did not wait until measured inflation was below two per cent, or even below three per cent, before easing; the first easing in this cycle in July occurred when the inflation rate was 3.1 per cent.

Similarly, there have been suggestions that the Reserve Bank has a speed limit above which the economy cannot be allowed to grow. The figure usually cited was 3½ per cent. Such a suggestion is, of course, incorrect, and I have pointed this out on many occasions. In case there is still any doubt, you only have to look at our behaviour in 1997. As I said earlier, the economy has been growing at four per cent per annum so far in 1997, yet it did not stop us easing monetary policy twice so far this year. If we are getting reasonable news on inflation, and our inflation forecasts are in good shape, we have no objection to the economy growing by four per cent or four per cent plus. When looking at the whole picture of employment and unemployment, monetary policy is, as I said, only a small part of the story and it mainly concerns the cyclical aspect of unemployment. If we look at the really big changes in employment or unemployment over decades, rather than years, monetary policy plays a small role.

The biggest change in employment performance of which I am aware is the contrast between the United States and continental Europe. In the United States the unemployment rate is back at its level of the sixties, whereas in Europe it is about five times as high as it was in the sixties.

A few European countries have done better than that, including the United Kingdom, but others have done worse. If you try to explain the superior US employment result by faster economic growth you get nowhere. Europe has grown as fast as the United States over these three decades. It just has not generated jobs. The explanations for the poor European performance on jobs all centre on various types of rigidities, especially in wages and conditions of employment, but also the social security system and the various difficulties involved in starting businesses and the subsequent lack of entrepreneurship.

I do not intend to go into this in any depth because it is a huge topic—I only raise it to point out that there is much more to the story than the growth of demand and the role that monetary policy plays in it. In other words, even if we succeed in having good economic growth and sustaining it for a longer period than in earlier expansions it will not solve all our unemployment problems. We will make some progress but it is too optimistic to think that we will be able to emulate the Americans and return to the 1960s levels through macroeconomic policies alone.

I saw in the paper yesterday someone from ACOSS saying that the big challenge for Australia was to achieve US style economic growth and lower unemployment without US style inequality and poverty. I think this is a realistic starting point—a sensible way of looking at it. It shows an awareness of the current trade-off and I hope that, with some ingenuity, we might be able to improve on the current trade-off. My only quibble is that we already have achieved US growth rates; in fact we have exceeded US growth rates. It is the US unemployment rate that has eluded us. This is something that people like myself who studied economics in the sixties finds surprising. In the sixties it was the United States that was always criticised by countries like Australia and countries in Europe for its high unemployment. Now the boot is on the other foot.

There is a lot more that I could talk about but I will confine myself to only one further topic, which is a very different topic from what I have been speaking about, and that is the subject of bank lending and bank margins, particularly bank lending for small business. I mention this because it is a subject that this committee has taken a particular interest in over the years. In fact the first large-scale inter-country study of Australian banks' margins and banks' profitability was undertaken by the Reserve Bank at the request of this committee in August 1994.

We did another study, at the committee's request, recently which was published in our October bulletin. As committee members also know, the Reserve Bank has been meeting with its small business finance advisory panel since 1993 to discuss the provision of finance to that sector. We formed this panel because we were worried that banks had become excessively risk averse and were reluctant to lend to small businesses in the early part of the recovery from the 1990-91 recession.

It has been a slow progress but competitive pressures have been gradually working their way into banks' margins—that is the difference between the average rate they earn on their loans minus the average rate they pay on their deposits. These margins are now lower than at any time since we have been collecting statistics and the biggest fall has occurred over the past two years. Clearly the entry of mortgage originators into the housing market was the biggest single event in this development and it led to the margin on housing lending falling from a level which was high by international standards to one which is about average.

We are now beginning to see hotter competition in lending to small and mediumsized businesses and partly this is the result of the need felt by many banks, particularly the regional ones, to reduce their reliance on the now much less profitable mortgage market. In this sense, it shows how competition slowly works its way through the system. I confess that it has taken a lot longer than I expected, and longer than I hoped, but I think we are finally getting there.

That brings me to the end of my introductory remarks. We have certainly had a very eventful period in the month leading up to this meeting, and we have all been working hard to keep up with events, particularly events on the international scene. I have already thrown away about three previous sets of notes for these opening remarks; they became obsolete within the space of a week. But, as I said at the beginning, we are happy to be back here again and happy to answer any questions you have. I hope we have as good a discussion as we did last time. Thank you very much, Mr Chairman.

CHAIR—Thank you very much, Mr Macfarlane. That was a very comprehensive opening statement. While you said that you could put a lot more into it, I think we did get covered quite a lot of topics. What we have not covered so far, I am sure the committee will be very keen to bring out in questions.

I thought it was very encouraging also to hear your comments that you believe that Australia is in the best position it has been for a quarter of a century to face the current economic challenges. I think all Australians will be very encouraged to hear that.Notwithstanding your earlier comments, at the last meeting you had come almost two days earlier from a meeting with the board and you had something in your pocket—another interest rate cut—which you were reluctant to tell us about at the time. I am just wondering, as an opening question, what have you got hiding in your pocket this time?

Mr Macfarlane—If we go back to May, we did not have that in our pocket; we nearly had it in our pocket. We had a feeling that there was a lot of evidence that suggested that it would be good for the economy to have an interest rate cut. But at that stage, we were held back because we had some disturbing figures on earnings; we had some reservations about them. What they were showing at that stage, literally, when the figures came out, which was just before our board meeting and just before our meeting with this committee, was a pick-up in earnings, a pick-up to over 4½ per cent, and a pattern that looked like a gradual acceleration. That was a disturbing development even though we hoped, and had some reason to believe, that it might subsequently prove to be incorrect. But that was enough for us to sit on our hands for a while.

It was not until a little over a fortnight after this committee met that we got some more details on those figures. They confirmed our earlier suspicions and so we went ahead and eased immediately afterwards. They showed that our suspicions were correct in that the figures seemed to be showing an unrealistically high rate of growth of public sector earnings. We thought they were wrong, but we did not have the split until after the committee had met. They actually revised down the aggregate figure for the March quarter and, as I said, when you looked across the pattern over the previous year it looked relatively steady—I cannot remember what the figure was—at 4.2 per cent or something, rather than accelerating and going up through 4.6 per cent.

We thought on the weight of evidence, those three pieces of evidence. In a sense, we went back and revised our earlier decision and went ahead and eased. We then got a figure three months later, the June quarter, which was also quite encouraging. It showed good figures for inflation and it showed that that apparent slowing in earnings had continued, and so we had another easing of monetary policy in July.

But you are right to say that the last meeting was somewhat inconvenient for us, that we were getting some misleading signals before the committee met and we were only able to really clarify them sometime afterwards.

Mr LATHAM—So a downward revision in AWOTE of 0.3 per cent—is that significant? It drives and triggers an interest cut?

Mr Macfarlane—No, not of itself. If that was the only thing, it would not be significant.

Mr LATHAM—What were the other factors?

Mr Macfarlane—The other factors included, as I said, that we thought there was some tendency to an upward bias in the way these things were calculated. When we looked at the public sector ones, we just thought they were wrong and were overstating it. This was just our suspicion. This was not anything concrete. We had some reservations about it because of that. We did not have that breakdown at the time. By the time the new information came out, we had the breakdown of the private and the public sector.

Mr LATHAM—Which was up.

Mr Macfarlane—Which demonstrated, firstly, that the bias was clearly there—as we had suspected—and, secondly, that the aggregate had been revised down. Once you revised that down, and started to look at the thing in the medium term context again, you could not really see any sign of an upward trend. It did not suggest necessarily that there was a slowing in earnings; it suggested that the possible pick-up was not going to be there. It suggested that the thing had flattened out at about one per cent a quarter. It was not ringing an alarm bell anymore.

CHAIR—Can we just pursue that in the current context? What sorts of factors that you do not already have would you be looking at to see whether or not you could have another easing in the next month or two?

Mr Macfarlane—You would be looking at the whole gamut. You would be looking at everything. You would be looking at your inflation forecast and your forecast of economic activity. You would be looking at what is happening in financial markets. If I was to try and answer that question, I could go on for a very long time.

CHAIR—But your inflation forecasts in the semi-annual report show that you are pretty confident that it is going to stay down for another 12 to 18 months.

Mr Macfarlane—Yes, our inflation forecast is satisfactory. It is not as low as it was a month or two months ago. It has actually crept up a little, not that it is a worrying development. In fact, you could make the opposite case. I think you could have made the case two months ago that we had an inflation forecast which was pointing to inflation staying below two per cent for an extended period. Of course, that is not our intention. The aim of an inflation target is not to have inflation stay below for an extended period. But, the events of the last six weeks have caused us to move that up a bit. Whilst we may be below the two per cent for a quarter or two, we suspect that by the middle of next year we will be back there.

Three things have caused us to move it up. Firstly, one of the major reasons it got below two per cent was the delayed effect of the appreciation of the Australian dollar that occurred through the second half of 1995 and the first part of 1996. We had a big appreciation then and it has been essentially flat since. Those effects take time to work through, so they were explaining why inflation came down as much as it did.

If you look at the components of inflation, you will see that the imported component was negative. That is what pushed that down. Even if the exchange rate had just stayed steady, that would gradually have faded away. What has happened is that the exchange rate has not just stayed steady; it has actually come down a shade. It has come down, as I quoted, from about 58 to 59—it was over 60 last time we met—and has come down to about 57. We are losing the downward pressure from the earlier appreciation. We are probably going to add in a tiny bit of upward pressure from the recent depreciation.

Secondly, I have really only explained the first episode on wages. I explained how the revisions to the March quarter were very encouraging and how the June quarter was even more encouraging. There was an extremely low figure in the June quarter. We started to build that into our forecast as though we had actually turned a corner and were going down and the earnings were decelerating. But when the September figure came out, it was actually quite a high one. When you averaged the June and the September figures—which I think is the logical thing to do because one was abnormally low and the other was abnormally high—you get an underlying picture of earnings growing at four per cent; maybe a tiny little bit above four per cent, which is consistent. It is not alarming, but it is consistent with an inflation performance of two point something.

If you look at some of the other broader things that underlie inflation, the private sector services have grown at about 3½ per cent over the last 12 months and the nonimported goods, the locally produced goods, about 1.8 per cent. If you put those sorts of numbers together—4.1 for wages and take off a bit for productivity—you get two point something for inflation. You look at the services, you average the domestically produced services of 3.6 plus the domestically produced goods of 1.8, and you are getting figures around two point something per cent. Our view is that the underlying is roughly where we want it to be. Our average will turn out roughly where we want it to be when the effects of the earlier appreciation wears off.

CHAIR—In short, you are saying the current interest rates are about where you want them?

Mr Macfarlane—In a sense, they always are, Mr Chairman. It would be very difficult for me to come along here and say, 'Sorry, but they're not where I want them. I'd like them to be somewhere different.'

CHAIR—Your predecessor used to talk about the level of the dollar and say what he would love to see happen.

Mr Macfarlane—He rarely said anything about the level of the dollar—very rarely. These things are continually under review. We are looking at every piece of information as it comes in. We are evaluating where we think it should be and we have had our formal evaluation just two days ago at our board meeting. There is certainly nothing to have changed since then.

Mr WILLIS—On that point of the inflation forecast, I think you just said then that you expect it to move back into the two to three per cent range in the middle of next year?

Mr Macfarlane—The statement says by the latter half of next year.

Mr WILLIS—In the semi-annual statement, it says probably towards the end of 1998. Does this indicate a pretty recent revision on your part?

Mr Macfarlane—Probably a bit more native scepticism on my part than the forecasters' part, I think. What has happened was we were moving the inflation forecast down through most of 1997 through to about two months or six weeks ago and we have gradually been moving it up a bit since then. Professional forecasters always move rather slowly. I have probably moved a tiny step faster than they did.

Mr WILLIS—On that point also, in terms of the Asian shake-out effects on inflation, some forecasters have been indicating that they think that, despite the devaluation, the shake-out could be actually good for us for inflation, because there is likely to be, with considerable excess supply in Asian markets, a fierce effort by Asian countries to export at very competitive prices. This would indicate a lowering of prices more than the devaluation perhaps from those countries. This would give us, despite some devaluation by ourselves on the TWI, a benefit on inflation through a price effect in the initial prices in the original currencies of these countries. You do not seem to be making any allowance for that whatever. Why aren't you? Do you think this could have any possible effect?

Mr Macfarlane—We have actually made allowance for it. In fact, I think we have probably made too much allowance. We have even got a mention of it in the overview part of our half-yearly statement.

Mr WILLIS—I missed that.

Mr Macfarlane—Some of my people have been very keen on that effect. I have been a bit more sceptical and I have said, 'Hang on. Basically, we have depreciated.' We have gone up against the ASEAN four—this changes on a day-to-day basis—but broadly speaking, we have gone up against the ASEAN four and we have gone down against virtually everyone else. I think the first thing you have to assume is that the normal relationship that people put in their forecasting equations will be the same. In other words, the aggregate level of the trade weighted index will be the thing that determines the inflation impact.

It is true that there may well be particular industries where we will see some intense competition. I have quoted in my introductory remarks some cases where I think there has been overcapacity. The classic case is semiconductors, where the prices, which I cannot remember, have plunged. They have plunged like commodity prices go down: 40 per cent or 50 per cent per year. So there has been that. That will make it cheaper for people buying personal computers, I suppose, and a few other items. There has been a bit of it in the automobile industry, particularly from Korea. We have already seen a fair bit of that come through.

I could imagine that there will be, in certain areas, quite intense competition and price cutting amongst those countries. They are competing not just with each other but also very much with Taiwan and Korea. But there is a whole range: from all the other countries in the world apart from those four, mechanically, the imports we get will go up in price.

Mr CAUSLEY—It is a bit of a double-edged sword, is it not, because it has an effect on our ability to export and also on our employment?

Mr Macfarlane—Any change in the exchange rate will affect you not only on the import side but also on the export side. What it is saying is that, apart from those four countries, our capacity to export has gone up.

Dr NELSON—Mr Macfarlane, I have got two questions, one of which relates to what you have said today, and one of which does not. The first is that you have made the observation that, despite European growth rates, there has been a failure by the Europeans to make any substantial impacts on employment growth, and on unemployment in particular, and you contrasted that with the US. You have said in relation to Europe that wages, the social security system and difficulties in staffing business are three of the reasons why that might be the case.

At the last hearing, I asked you why, after six years of sustained growth, we still have around 8½ per cent unemployment, and you were reluctant to nominate the other areas. Are you essentially saying that in Australia, if we are going to make significant inroads into unemployment, we actually do have to look at the level of wages and at the way our social security system relates to the employment market? Also I presume that, when you say difficulties in staffing business, you mean labour market reform. Then I have a second question to ask.

CHAIR—On that, or on another subject?

Dr NELSON—On another subject.

Mr Macfarlane—The question is a very big one, a huge one; and I have to confess that it is not one that I am actually an expert on. It is something that I am obviously very interested in—because, as I say, I look around the world and I wonder how it is that the US has got such low unemployment and yet continental Europe has got such high unemployment. That is the starting point that people have got to look at. I think that some of that is happening. I saw a reference to a conference at Melbourne University and some comments that Professor Garnaut made that I thought were very encouraging.

I have already mentioned how the representative from ACOSS was putting it in that sort of framework, that somehow or other we have to find what it is that the Americans have done but not necessarily to do slavishly what they have done—see if there is some way you can do it so as to pick up the good features of that and do it in a way which is perhaps not as heartless as a lot of the members of the community would view some of the American measures as being.

What that means is that everything has to be up for grabs. You cannot turn the clock back to the 1970s and say that we will do it through big government expenditure or through easy money. You have got to do it through some of the measures that seem to impact directly on the employment contract. Some of that debate has been going on here already. We have had a big debate on the unfair dismissal regulations. It is quite clear from the European experience that one of the things that has contributed to their high unemployment rate is that, if you make it very difficult to get rid of people, you make employers very reluctant to hire them in the first place, unless they are absolutely certain that they are going to be top class.

Employers will not take a risk with someone who has got some doubt over them because they were formerly unemployed or because they are low skilled, or whatever it is. That is an example of where I think we have actually gone down the right path and have had the right sort of discussion.

There are a whole lot more things that we will have to look at: all sorts of things to do with flexibility of hours and shifts, and pay structures and youth wages, apprenticeship wages, and the structure of unemployment benefits. I do not want to beat up on the unemployed, because I do not think that our replacement rates are actually overly generous. I do not think that Australia is overly generous there, but there is some evidence that, in countries where the unemployment benefits are not everlasting, but where there is a benefit for a particular sort of search period and then the benefit goes down after that, that does actually encourage people to return to the work force much more quickly.

There is the whole issue of on-costs: payroll tax, workers' compensation, insurance and a lot of those things. Of course, the other classic one is the high effective tax rates that a lot of unemployed people face because of the interaction between the social security and tax systems. The Melbourne conference sounds as though there are a lot of people starting to come up with creative ideas for something to be done about that. The purest solution is negative income tax, and there are other things like the US's earned income tax credit that people are starting to introduce into the debate. None of these sorts of structural things is, on its own, probably going to have a profound effect, but a number of them, over time, presumably will have a large effect. That is the constructive path to go down, and I can now see it happening that people are starting to go down these paths.

CHAIR—That was a fairly comprehensive answer to a long question. I would like to clarify one point. At the beginning, you did bring in the question of the unfair dismissal: do you think that is a significant factor?

Mr Macfarlane—I am not an expert on the Australian unfair dismissal regulations. I know that there have been changes made and that there is big debate as to whether the changes are big enough. I cannot really comment on that. I do know that the economic literature that compares unemployment rates in different countries indicates that that is a significant factor.

Dr NELSON—But what you are saying is that growth in itself is not enough—which is what you said in relation to Europe.

Mr Macfarlane—Yes, that is right. Growth will do part of it. But it is not because the US had faster economic growth than Europe or faster economic growth than Australia, because it did not: it is structural things that explain it.

Mrs GALLUS—Mr Macfarlane, can I take you back to what David Hawker was saying, when the words perhaps were not the right ones but you were happy with the setting? Obviously you are, but I suspect that Mr Hawker was suggesting that there might be a belief out there that they should be lower. A couple of things you have said would indicate that perhaps that would be a way that we should be going. We have indicated that we are expecting slower economic growth. We still have high unemployment. You mentioned the attitude of the rest of the world to the region, which Australia was included in. I reminded of a cartoon—in, I think, the *Australian*—of all the Asian tigers running around in chaos and a kangaroo sitting with a notice around its neck saying, 'I am not an Asian tiger'—trying to distinguish ourselves from the region.

Be that as it may, we are affected by the region and, yes, on one side we do have the importing countries that we major import for, where the dollar has depreciated; but it is depreciating against some of those South-East Asian countries, and you yourself mentioned motor cars. Korea has enormous capacity in the motor vehicle area and, with our dollar higher in comparison with the Korean, we are going to see a great influx of those cars into the market, including a new challenge to the V6.

Taking all those things into account, it would seem there would be definite pressure to lower those interest rates for more expansion, coming into the future. If I can add one other element, there is also a concern that, even prior to the Asian crisis, the interest rate that was set was actually not conducive to growth. If looked at in a number of contexts, it was actually neutral in that area and was not a growth target.

Mr Macfarlane—Not just we ourselves but also private forecasters accept that to date in 1997 the economy has been growing at about four per cent. Two of the numbers are on the board and the other one relies on the forecast for the September quarter; so essentially the economy is growing at about four per cent. We still have a significant amount of stimulation, I believe, in the system, from the five cuts in interest rates that have been made.

You have to be rather patient in this game. The effect of monetary policy has quite a long lag and, if you cut things, you have actually got to wait to see them work their way through the system. You do not get instant results and, if you simply cut again and do not get instant results again, you end up destabilising the economy, and that is one of the things that can potentially lead to a boom-bust economy. My view, and the board's, is that, with the economy growing at the rate it is, and with the inflation target forecast that I have outlined, and given the fact that we have not seen the full effect yet of the five easings of monetary policy that have taken place in the past sixteen months—and that, in fact, we have seen very little effect from the two most recent ones—we really have got some stimulation still to come through.

Another way of looking at it is this: is the economy constrained by interest rates? Is the cost of money and credit too high? Are people afraid to use it because it is too high? The answer is clearly no: in any of the surveys you do of business, even of small business, they do not regard cost of credit or availability of credit as being a constraint on them; in fact, the use of credit is going ahead at a fair clip. Whichever one you look at—personal, housing or business credit—it is growing at about 10 per cent per annum, which is certainly more than adequate for an economy where nominal GDP is probably growing at about six per cent. I do not see signs of the economy at the moment being constrained.

On the exchange rate, basically we sit back and see what happens. That is what we have been doing. There were people in financial markets earlier in the year who were very worried about what was going to happen there, because we did something that was pretty well unprecedented: we lowered our interest rates to below US interest rates. I cannot remember that being the situation before, in my career. In fact, what happened for most of that time was that the exchange rate did not do very much. More recently, it has gone down.

If we were running interest rates that were too high and a monetary policy that was too tight, we might be tending to see upward pressure on the exchange rate. We have not seen that. We did not see it even before the Asian crisis, and now we have seen it come down a bit. Our feeling is that these rates, which are almost as low as any of us can remember in our working lives, are not constraining the economy.

Mrs GALLUS—Historically, you said before, we have been a boom and bust economy. The situation is now totally different from what it was in the past. Comparative to other countries, we are not in that extremely low position that we were in historically in our own country.

Mr Macfarlane—We want to remain not a boom and bust economy, too. That is one of our considerations. One way in which you have to be cautious is that you have to actually wait for the effects of things to happen. We know that there is some more stimulation coming through. All the work that has been done on the lags in monetary policy suggests that there is more coming through. If we are starting where we are and there is more coming through, we are in a reasonably comfortable position.

Mr LATHAM—I wanted to raise a few issues on central bank credibility.

CHAIR—We are doing monetary policy at the moment. Is this a new topic?

Mr LATHAM—I mean central bank credibility in monetary policy settings, of course. I am not going to raise other issues at this stage. It appears that four of the five rate cuts have caught the market by surprise, and I have seen some commentaries by market analysts who say that this is a worrying trend because it demonstrates a lack of transparency with the central bank in Australia. The bank is doing things that the market might judge either to be against the fundamentals or against the way in which the market has interpreted certain messages out of the bank. Does that criticism concern you and, if so, what things would you be trying to do to address it?

The second issue of credibility is in terms of wage setting and the impact of bank statements and actions on the thoughts of wage negotiators. In particular, I note at the end of the half yearly report you again raise some concerns about the future direction of wage movements. I put to you that wage negotiators might well say to themselves, ‘Last time he was before that committee, he said that broader wage developments do, however, present some risk to the inflation outlook and not long after policy was eased.’ There might be a temptation for wage negotiators to think that the bank just automatically adopts a hawkish attitude on wage movements. We have seen instances where that rhetoric does not accord with bank policy, and for that reason they should not be too worried about what the bank has got to say.

Mr Macfarlane—You have two questions there. The first one is in respect of credibility with financial market economists. The problem with that allegation is that the only way you could gain perfect credibility with them would be to always do exactly what they thought you were going to do, which in other words would mean that you would do exactly what they wanted you to do.

Mr LATHAM—Isn’t there a difference between what they want you to do and what they think you are going to do?

Mr Macfarlane—No. Let me go back through a few examples. If we went back to the phase where we were tightening monetary policy in the second half of 1994, the market still thought that we would continue to tighten monetary policy through the first quarter of 1995—in fact, virtually through to the middle of 1995. So, month after month, if you look at the 90-day interest rates compared to the cash rates, they were assuming we were going to tighten them. For six months in a row in that period, we let them down because we did not do what they thought we were going to do. I think we did the right thing; I am very pleased we did the right thing.

Again, some of that has happened during this year. There were periods until very recently, until about a fortnight ago, where those 90-day rates were below the cash rate. They have seen us ease a couple of times and assumed that we were going to do it again. We did not do anything, so we let them down. In other words, you can let the market down or you can surprise or disappoint them just as easily by doing nothing as you can sometimes do by doing something that they did not expect.

At the end of the day, you really are backing your judgment against theirs. You are saying, ‘I do what I think is right even if it is different from what they are expecting.’ I think you can make the claim that, of these five easings, you are right with three of them. If you looked at the prices in financial markets, they were not expecting three of them. They expected two of them but not three of them.

At the end of the day, you are backing your own judgment against theirs. You have to do what you think is right and not be intimidated even though you know that, if you do something that is different from what the financial market is expecting, you run the risk of an adverse reaction. Particularly if there is an easing, you run the risk of people saying, 'They have gone silly,' or 'They have decided to become irresponsibly lax in their monetary policy,' and you run the risk that they will sell off the dollar and do things like that. But you have to be prepared to take that risk.

The market is always looking for a sort of rule; to some extent, they are always looking for you to follow some very predictable rule. The other answer is that, if we did follow a totally predictable rule, everyone in the country could predict us and you would not need to employ money market economists. But there is always this tension between central banks and what in America are called Fed watchers. It is quite a healthy tension: they annoy us sometimes and obviously we annoy them sometimes.

We particularly annoy them if we do something they did not predict, because their boss kicks them in the pants very hard, and then they complain about us. They say, 'How could we possibly predict those people? They are just irrational and unpredictable.' I do not think we are, considering the effort we put into it. In fact, in respect of those last five easings, which one of them do you want to say was wrong? Which one should we not have done? Despite the fact that three of them were not predicted, I think they were still the right thing to do and I stand by them.

Mr LATHAM—And the second issue, about wage setting?

Mr Macfarlane—The second one on wages—yes, you are probably right in that we are, and all central banks are, sensitive to wages and, given the history of the last couple of decades, probably a bit cautious there. As I said, I think we were a bit unlucky—we have been over this one before, Mark—the way those figures came out this year; it did not help logical policy making as much as it could have.

But all we can really do on wages is set very broad parameters. Some people were quoting the phrase 'the Reserve Bank is now the wage policeman'. I am not sure what that means, but I do not think we are, in the sense that we are not experts on wages and industrial relations and we cannot sit down and argue the point about this award or that over-award payment or whatever. All we can do all along is to say, 'We think the economy performs much better at low inflation—the sort of inflation we had in the fifties or sixties,' which we now encapsulate in the phrase 'an average of between two and three'—'and if you want to stay there then, really, given the sort of productivity performance we are capable of in this country, aggregate wages should really be going somewhere between 3½ and 4½.' At the moment, aggregate wages are in that corridor, and that is really all we can do.

The problem where you think we cried wolf back in May was that it looked as though we were going outside that corridor. Now the statistician has said, 'No, that's wrong; they weren't.' But it did look as though it was the case. Of course wages are always going to be the biggest structural difficulty for Australia because—I have been through this before—we are trying to return to a low inflation growth economy like we had in the fifties and sixties, after two decades of high inflation, and at the same time as trying to do it, we are actually going through a once in a century change to the wage setting structure in Australia.

We have moved from a centralised to a decentralised system. Not just under this government, but gradually under the previous government as well, we have moved from probably the most centralised wage fixing system in the OECD area to a decentralised one. We are doing it at exactly the same time as we are trying to return the economy to a low inflation growth economy, and so there was always a risk that something would go wrong there. It has actually worked out a lot better than some previous fears would suggest, but that was always a risk.

CHAIR—Before Dr Southcott asks his question, try to keep this on monetary policy. We will then take a break before we get on to wages, which, in the light of the recent announcement, maybe will have some more bearing on some of the comments that have already been made too.

Dr SOUTHCOTT—Just on that, do you have a view on where the non-accelerating inflation rate of unemployment actually sits? The IMF has estimated it at 7½ per cent. In the United States, they have actually undergone some revision on where that speed limit might actually be. In Australia, has the shift that we have seen from the award system to workplace agreements shifted that rate of unemployment at all? Also, just for your benefit—you might like to comment—the October seasonally adjusted unemployment figures were unemployment at 8.4 per cent, overall employment dropped by 200 and full-time employment fell by 9,900.

Mr Macfarlane—The first comment is this. I will comment on the second part because it is much easier than the first part. That is not a bad figure for employment, because we had this huge jump last month of 75,000. Usually with economic statistics, if you have a huge jump in one month, you have a retrace in the next month, or if you have a huge fall, you have a rise in the next month. The fact that it has maintained that level is good news. The unemployment rate, you said, was—

Dr SOUTHCOTT—8.4 per cent.

Mr Macfarlane—Yes, 8.4 per cent. That is, I think, the lowest one we have had this year, although I do not know whether you could read all that much into it. That is mildly encouraging.

As for NAIRU—non-accelerating inflation rate of unemployment—it is not a concept that I am a great fan of. In principle it is not bad but, when you come to measure it, it cannot be measured with any precision, in my view. Because it cannot be measured with any precision we cannot use it as a guide for monetary policy, so I am not at all comfortable about using it in Australia. There are other things that you can use that perform a similar function. You can look at the general amount of spare capacity in the economy and you can look at how far GDP is from its trend growth, which will do a similar function. There have been various studies done in Australia, particularly by academics and by people working for government departments of employment and what have you. The numbers they get vary so widely that you simply cannot use them as a practical guide to policy.

Dr SOUTHCOTT—So you do not even have any feeling of where it might sit? Is it something you only find out when you hit it that—

Mr Macfarlane—Yes, I think that is right—that is the problem. To be at all confident you know where it is, you have to rev the economy up to the point where inflation starts accelerating. This is not what you are trying to do, because you are trying to get a smooth long expansion, not a short sharp one that will end in high inflation. If you try to do it before the event it is just too vague. If you have a more flexible labour market it should go down, in principle. That is the US example. The literature all comes out of the US, and the US says, 'Look, we've got a low NAIRU. Our NAIRU is less than five because we have a very flexible labour market. Look at Europe: it is probably more than 10.'

Mr ANTHONY—On your monetary policy, are you happy with the current measure within the CPI basket of goods? How do you value the asset price inflation that we are getting now, more particularly in this city? Do you think there will be problems because of the shift in our prudential controls now they are not exclusively with the RBA? In light of those wage figures—I notice in your report on page 19 you talk about it—obviously, for business confidence you still have to have control of labour costs. As well, on page 38 of your report you say the ACTU is putting forward some fairly big claims. What type of impact do you think that will have on inflation?

Mr Macfarlane—There are about three questions there.

Mr CAUSLEY—Do not answer any.

Mr ANTHONY—We only get one stab at this.

Mr Macfarlane—The first one is: what about asset prices? Should you have them in the CPI? No, you should not have them in the CPI. I think the CPI should only be goods and services, but you have to look at asset prices. In fact, if you go back to the eighties, it is one of the things we should have looked at a bit more closely. At the time it was rather difficult to do because there were not any established price indices. I think we are in better shape now. There are certainly price indices for housing, for residential property. There are beginning to be better price indices for commercial property, which was the important one in the eighties, I suppose. If there had been a good index we might have looked at it a bit more closely. And, of course, we have got share markets and things like that.

You have got to look at them, but you should look at them separately from the CPI because they do tend to have a different life. The classic is Japan which had low CPI inflation all through the eighties and an enormous asset price boom. If you have that combination it is an extremely difficult one for monetary policy to handle, but I do not think we have got that at the moment. It is true that residential property prices in parts of Sydney and parts of Melbourne are going up very quickly, but I do not think that is an inflationary signal; I think it is a change in people's preferences. So we look at it, but we do not worry too much about it.

The other one I think you mentioned to me was the ACTU claim for the safety net review. We are still looking at it. As I said, we are not the experts. We are not wage policemen who go through fine detail and say, 'This award should change by that much.' We basically look. We hope we can set a sensible macro-economic corridor for the country that others, like the commission and wage bargainers can work within. Certainly I think it is very early days on that one yet. They still have not decided when the hearing is going to be and, if it is like this year, the hearing will not be until early 1998.

Mr WILTON—Are you saying that the bank has not costed the ACTU's living wage claim?

Mr Macfarlane—At this point, no, because you have to do some quite complicated things. You have to make some quite complicated assessments on the amount of absorption to over-award payments and that sort of thing. That is quite a complex exercise. It takes a lot of time and you have to talk to a lot of experts, and we have not done that as yet.

Mr McMULLAN—You will obviously have to do that with regard to this claim, if you do not mind me saying so. It is designed not to apply to people who—

Mr Macfarlane—I know, but then you have to decide whether the design is going to work out that way or the design is not going to work out that way. It is really an empirical issue—

Mr McMULLAN—That will not be a consequence of the decision; that will be a consequence of what other people in the market do who are already getting big increases.

Mr Macfarlane—It seems to me that it is an empirical issue; it is not something that can be determined by design.

Mr HOCKEY—This is a two-part question. The first part really relates to equity markets. You say in your annual report that there was basically a record level of equity raisings over the last six months—$6.6 billion. I suppose we have seen over the last 12 months the effect of international hedge funds prowling the world markets looking for susceptible economies. I suppose over the last 10 years there has been a significant change in the hedge markets. They have become more sophisticated and the world markets seem to trade volatility more than ever, because they are making money out of volatility now and they were not necessarily doing so some years ago. Do you think that we, particularly retail investors and mums and dads out there, have to come to terms with the fact that equity markets are going to be more volatile now than they ever have been in the past?

Mr Macfarlane—They have been more volatile on a day-to-day basis, although I am not sure that the day-to-day volatility affects the retail investor all that much. I think the retail investor and the whole economy is more vulnerable to a massive sort of long-lasting misalignment and then a big correction. I think that is probably the bigger worry, not the day-to-day volatility. The bigger worry is that for some share markets, although it does not apply to the Australian share market, there are a lot of astute people who have been around a long time who are worried that there is a fundamental misalignment in the form of an overvaluation. I think that is likely to have a greater effect on the retail investor planning for their retirement or what have you than the volatility. It is true; you are right: the daily volatility has gone up, but I do not think that is a huge problem.

Mr HOCKEY—With that increase in the level of volatility, though, it seems that businesses will perhaps have a fight to leverage lower interest rates. Equity is quite expensive. In fact, with increasing volatility, raising equity is going to become more expensive than it is to raise debt. Do you think that will have any impact on the level of domestic savings?

Mr Macfarlane—No, I do not think it is going to be a problem. It would be a problem only if business over-leveraged, and I do not think business is going to over-leverage. It has been through that once before. It did that in the 1980s. It has reduced its leverage and now there is some modest increase in leverage going on which, because it is happening at a moderate rate, is really a sign of confidence rather than anything that we would want to worry about. As for the retail investor finding equities to invest in, I think there are going to be plenty of them around. Even if the private sector reduces its new offering slightly, we have privatisations, demutualisations and things like that occurring. So I think there will be plenty of avenues for the retail investor to invest in equities.

Mr WILLIS—Just to come back to the forecasts about the impact of the Asian shake-out on the economy, you mentioned the forecast that had been made by private sector analysts—roughly around one-quarter you said on average—and the OECD figure of 0.3 and 0.4. I was not sure that you actually endorsed any of that. I appreciate the difficulty of this, but has the bank made any assessment of what they think reasonable forecasts for the economic impact on us would be in the next year or so? Are you endorsing those private sector analysts?

Mr Macfarlane—We are not going to endorse them. We have got matrices of forecasts. You can run through how many countries are involved. How much does their GDP slow down by? What does it do to their imports? What does it do to their exports?

Mr WILLIS—I am asking what is your best expectation?

Mr Macfarlane—I do not want to stick my neck out at this stage. I think it is very unwise, particularly for anyone in this part of the public sector or other parts of the government, to go off half-cocked at this stage, although I think there are a lot of private sector economists and journalists who have the opposite set of incentives. They are very keen to come out with an assessment and have a lot of notice taken of it. But at this stage I think it is far too early.

It became a big issue that people started to look at as of about July. It became a potential crisis, meltdown, et cetera, as of about the middle of October. It has now become a more benign picture again compared to what it was at say 20 October. It is changing so quickly that anything you put out I think you could be embarrassed by within a week. I am sorry, Ralph, but I just cannot commit myself to a figure, a percentage point change in GDP.

Mr WILLIS—You said in August in a speech that you thought we could grow at 4½ per cent or even more over the next couple of years. Do you still think that?

Mr Macfarlane—I think we are growing at four per cent now with some internal monetary expansion still in the pipeline. But then, on the other hand, we are going to receive some contractionary effect of some size from Asia. I do not know how big it is. I do not know how those things are going to be offset. I also have to keep reminding people that there is the rest of the world. North America and Europe are much bigger regions economically than Asia. Certainly Europe is starting to look a little bit better and North America is doing extremely well.

There are a whole lot of other things, too, that you have to take into account when you talk about our exports. Exports are not just exports. There is some evidence to suggest that our exports are more closely related to ASEAN countries exports than to ASEAN countries' GDP. In other words, a lot of our stuff is material that goes into their exports. With these huge depreciations they have had there will be a massive increase in exports in the short run.

There are other things which we are probably reasonably well off in regard to—that is, foodstuffs and necessities do not change enormously when there is a contraction. But there are other areas which are luxuries where there probably will be a big contraction, and the one that people are looking at there is tourism and some people say overseas education. A lot of Asians will deny that. They will say that that is one of the last things you cut back on. For those Asians who are determined to send their children overseas for education, Australia is now cheaper vis-a-vis Canada and the US than it was six weeks ago. So it is not clear how all that sort of stuff is going to pan out.

Mr WILLIS—Again, appreciating how difficult it all is, you said before that no one talks about the balance of payments, the current account, anymore. Do you think in a year or so they might be talking about it, given that various private sector forecasters are forecasting quite a substantial deterioration in the current account? I know you have just been making some comments which go to that point. Do you have any assessment overall about what the impact on the current account is likely to be of the Asian factor?

Mr Macfarlane—I think it is quite clear. Other things being equal, the current account deficit will be higher than it is this year and higher than we would have been forecasting it to be three months ago.

Mr WILLIS—Considerably higher?

Mr Macfarlane—The current account is economically very important in the very long run, but in the short run a change in the current account between this year and next year has, in Australia's case, tended to be important only in so far as it has given a signal to financial markets and financial markets have then behaved in a particular way which is detrimental to Australia, either by pushing down the currency or by pushing up bond yields and interest rates. I think there will be some increase in the current account, but the immediate impact of that on Australia is really a function of how financial markets react to it.

Mr CAUSLEY—I would like to talk about consumer spending. One of the major changes in recent times has been the contribution to superannuation. Instead of getting wage increases, employers have been paying into superannuation funds. What effect do you think that has had on consumer spending, and in fact is it putting pressure on wages?

Mr Macfarlane—The first thing with the compulsory aspect of superannuation is that it is the employers who contribute, not the employees. So, from the employees' perspective, when the first three per cent was put in the employees forwent a wage increase, but since then I do not think that has been the case. I think the compulsory employer contribution has probably not had an effect on what employees are receiving.

The other thing is that consumer spending is in good shape. Retail trade or consumption—whichever measure you want to look at: the narrow one, retail trade; or the broader one, consumption—have been growing quite strongly, particularly over the last quarter. The figure over the last quarter was so big that it was one of those you have to average with the quarter before to make any sense of it. But, even averaging the two, consumers have been spending. This has not been a weakness in the economy.

Some people come at it from the other way and they say they are spending too much and they are disappointed that the change in superannuation rules—the move to compulsory superannuation—has not had a bigger impact on raising savings. It would be easier to support the proposition that consumer spending seems to be unaffected by this. They have not cut back on their spending at all because their superannuation, their future wealth, has gone up. They have continued to spend.

CHAIR—Are there any other questions on monetary policy?

Dr SOUTHCOTT—Yes. I am just interested in what the Reserve Bank’s estimate is of the real cash rate—that is, the cash rate adjusted for inflation—which would be neutral in policy. We have had it put to us that it is about 3½ per cent and that with an official cash rate of five per cent and inflation at 1½ per cent current policy is neutral rather than the overwhelming view, which is that it is stimulatory. Do you have an estimate of the real cash rate?

Mr Macfarlane—I do not have an estimate of what the neutral real cash rate is, but I will say that I do not think that measure of taking five per cent and dividing it by 1.5 is the correct way of calculating the real interest rate. The correct way to construct a real interest rate is to divide the interest rate by inflationary expectations, not by observed past. If you are in a very stable situation where inflationary expectations are the same as the current inflation, they both give you the same answer, but that is not the case in Australia. Inflationary expectations still have not come down. People are not saying they will factor 1.5 per cent inflation per annum into all their calculations over the next year or the next decade. In fact, they should not either, because 1.5 is on the low side. That is going to be lower than the average inflation. We would like people to have an inflationary expectation of 2.5 and to use that. But in fact, if you actually ask people, you will find their expectation is a bit higher than that. It is probably about 3.4, and that is what you should be dividing the cash rate by to get the real cash rate.

Dr SOUTHCOTT—If you do not have an estimate of what the neutral real cash rate is, what do you use to assess what your stance is? Do you use yield curves, MCI or—

Mr Macfarlane—We do not use an MCI either. We have an idea of where we think the real cash rate is. Our view at the moment is that the current real cash rate is probably on the expansionary side of neutral. But, just like the NAIRU, these things cannot be calculated with enough precision to make them an operating rule for monetary policy.

CHAIR—Mr Latham has one more. Then we might take a short break.

Mr LATHAM—It is concerning the focus of monetary policy. I was fascinated by the speech by Dr Grenville in September when he was talking about the so-called new era for the business cycle, and can we read from this the judgment that the business cycle perhaps is a bit more predictable than it used to be because of the shortening of investment and inventory cycles and international integration. I also refer to the statement that was made that monetary policy cannot finetune the cycle, which seems to me to have been the boldest statement yet of what the bank really thinks the role of policy might be in the short term. Can we take from those commentaries that the bank is now taking a longer term focus on the impact of monetary policy than it might have previously?

Mr Macfarlane—The answer to that is yes, but if you want the details I will turn it over to Dr Grenville who is the author of this speech that you are quoting from.

Mr LATHAM—It is a wonderful speech.

Mr Macfarlane—What an introduction!

Dr Grenville—I should stop right now while I am ahead, shouldn't I. I think that, on the issue of whether the business cycle is smoother than it was, let us hope so, because we used to have a very bumpy ride. It looks like it is. We have gone for six years now with expansion. There are some reasons for thinking that we are in a better position to handle it now. In a policy sense, I think the float of the exchange rate helped greatly. I think the monetary policy framework which we have now also helps in keeping the cycle more under control. I think the economy itself has also changed in ways that might help to avoid the extremities of the business cycle that we had before.

In relation to what that does to monetary policy and finetuning, I do not think any central banks claim any great ability to finetune, so I did not see that as a controversial statement. I think it is, if you like, a recognition of the coarseness of the instrument which we have. On that, if you like, you can say we ought to be modest about that because we have much to be modest about, as every other central banker around the world would be modest about their ability to tweak a little bit here and keep us on an exact path.

So I think the economy will be a bit easier to handle. I think inflation may even be a bit easier to handle. I think the economy is more resilient in the face of shocks now and so we will not see such a big inflationary impact. But a lot of the reason for optimism is I think we have a better recognition in the community of the cost of inflation. I think we have better policy and we have that policy framework endorsed by the parliament. So I think, in that sense, we are better off all round. It is still no lay-down misere. I think it is still hard work to keep these things right, but I think we do stand a better chance than we did in the 1970s and 1980s.

Mr LATHAM—In practice, do you think this makes the bank's stance less interventionist? I know there had been criticism under the previous governor of the level of activity and intervention on monetary policy. Is there a chance, because of these changed settings with the business cycle, that policy can be a bit more passive and not as active as it might have been?

Dr Grenville—I think we all hope we will not have to move interest rates up to 18 per cent again and bring them down again. That is, if you like, a product of the economy going off track, and I think we can avoid that. Whether or not it means you just put monetary policy in the same place and leave it there over long periods, I do not see that as a very desirable thing of monetary policy. You do not want to finetune it but, on the other hand, there is no great virtue in setting monetary policy and never looking at it again. So I think we have it about right. We do not think we can finetune but, where we see a case for changing policy, we will be alert to that and do it.

CHAIR—The committee might adjourn on that encouraging note, and we will reconvene in five minutes time.

Short adjournment

[12.26 p.m.]

CHAIR—We have a lot of topics that I know members want to raise with the Reserve Bank, but we might move on to some of the issues that are involved particularly in South-East Asia for a little while. I would like to start by asking Mr Macfarlane a little about the level of central bank cooperation between yourself and other central bankers in the region. I understand there has been some work done there in the past. Would you tell us a bit more about it, and how effective it has been in the current test that it has had?

Mr Macfarlane—There is a fair bit of central bank cooperation. Australia is one of the most enthusiastic members of this forum of central bankers, which has got a rather funny acronym, EMEAP, which is the Executive Meeting of East Asian and Pacific central banks. There are 11 countries and I will go through them. Starting in the north: Korea, China, Japan, Hong Kong, the ASEAN five—Singapore and the ASEAN four—Australia and New Zealand. Interestingly, it does not include the US, and it does not include anything to the west of Thailand.

It has been a very good group. As a result of these meetings, we have very good relations with the other central banks, and we know our opposite numbers very well. We have done some useful things and in fact this group did make a contribution towards helping the Thai support package to be reached quickly. But, of course, central banks cannot commit the country's resources. We cannot say, 'Let's take some of our money and lend it to someone whom we like.' That is really the government's decision. The government makes a decision on committing the country's resources and, of course, it has to take into account other considerations such as foreign policy. So anything that is done which actually involves real money being put at risk has to be a joint decision between the central bank and the government, with the government playing the larger role. That was true in both the Thai and the Indonesian cases.

There has been a lot of cooperation, and it has made doing some of these things much easier. We also have had a lot of exchange of some of our people. We have someone up in Indonesia at the moment, who has been there on a number of occasions, helping them with their foreign exchange. We have had people in Thailand. We think the thing has been successful.

CHAIR—That opens up the question of the two particular situations Australia is directly involved in with Thailand and Indonesia. Could you detail a bit of what has actually happened so far in the Thai situation—what assistance Australia has actually given so far—and what exactly are the arrangements with Indonesia?

Mr Macfarlane—Before I get onto that, I would like to take the time to put these Asian economic disturbances into some perspective because I think it is important to do so. We have tried to do it in the half-yearly statement. Years ago, when developing countries got into trouble it was nearly always due to governments doing the wrong thing—basically having bad fiscal policy and bad monetary policy. They nearly always had big budgetary deficits, they spent money they did not earn, they borrowed it from the central bank, which is the same as printing money, and they ended up with high inflation and their exchange rates went to pieces. That was the standard way countries used to get into trouble. The IMF has a particular set of arrangements for handling that.

What we are seeing in Asia now is somewhat different to that. We are seeing a modern type 2 problem. One of the reasons why I think we have quite a lot of sympathy for these countries is that these countries, certainly by the standards of developing countries and by most standards, had run very good fiscal policy and reasonable monetary policy. They did not get into trouble through undisciplined policies in that respect. In fact, to some extent they got into trouble because they did too well, they became too popular and they attracted quite a lot of foreign capital.

When the foreign capital came in, the asset prices started to go up. The domestic banks also jumped in with their ears pinned back and started to lend money. It looked as though against a background of very strong growth rates anyone could make money. It seemed to be a bit of a gold mine. This money was invested; some of it was invested wisely and made a high return and some of the money was invested unwisely. A lot of it was invested in property or invested in industries which were already oversupplied, as I referred to before.

Compared with the old style economic disturbance, which was a government failure, to some extent the new style one is predominantly a private sector and banking failure, although you can then turn around and say to the government, ‘Why did you allow it to happen? Why didn’t you have much better bank supervision arrangements? Why didn’t you have a better body of commercial law?’ and all the rest. The main point of the disturbance is an overheated banking sector, overheated property prices, undisciplined lending and lending to related parties.

The pure macro-economic disturbance is really somewhat smaller than that. But at some point there is a macro-economic disturbance. In Thailand’s case, the thing that people noticed was that their exchange rate, which was fixed to the US dollar, was getting very high compared with their competitors. Because the US dollar was strong, people noticed that the exchange rate was getting very high and exports were starting to fall. Thai exports actually fell in 1996 before these disturbances occurred. It requires a trigger, and that was a sort of trigger.

So the same people who had been getting into Thailand as enthusiastically as they could started to get out. As capital departed—not just foreign capital but some domestic capital as well—the asset prices fell and the exchange rate went down because the capital was leaving. We have seen the exchange rates go down quite a way and they have probably gone down far enough in order to solve the macro-economic disturbance. In other words, the current account deficit will probably shrink quite quickly, as it did in Mexico, because of the fall in the exchange rate. If the fall in the exchange rate goes too far, it can exacerbate the domestic financial and banking crisis because a lot of people and a lot of firms—particularly a lot of firms—borrowed in foreign currency. So the lower the exchange rate goes, the bigger the repayment burden.

There comes a point where the depreciation of the exchange rate is no longer serving any economic purpose and is no longer equilibrating the economy. If you are in danger of reaching that point, then it is important that it does not go down any further and it is important that the confidence in the international community be restored so that this does not happen. And that is essentially where the international community—not just the international community but principally Asian neighbours plus the IMF—came in to help Thailand and then Indonesia. The aim of the help is not to solve the problem but to make sure that this contraction does not turn into a rout; to assure the international community that things are under control and that we do not end up in a self defeating spiral.

You asked for the details. The Thai support package, which I think amounts to about $17 billion, was agreed between the Japanese government and the IMF, who put in the main amounts, plus smaller amounts put in by Australia and—who were the rest of them?

Dr Grenville—Putting in a billion dollars each were Australia, China, Hong Kong, Malaysia and Singapore; and, putting in half a billion were Brunei, Indonesia and South Korea. There were also amounts from the World Bank and from the ADB. So about $17 billion in total.

Mr Macfarlane—From the Australian perspective the characteristic of the Thai package was that the support package was agreed to by cabinet—having been recommended by the various advisers, including ourselves. The funds were made available to Thailand through a central bank to central bank swap. We basically swapped some US dollars with Thailand in return for baht. So, within the Reserve Bank's balance sheet, our international reserves now include some more baht. We now have more baht than we had and less US dollars, but the interest rate we receive on these things is exactly the same as we did before.

The Indonesian arrangement is different. The Indonesian arrangement came much later and more slowly. I think the most important thing was the Indonesians had used virtually none of their international reserves. So the Indonesians already had $20 billion of their own money to start with. The second tranche for Indonesia was about $23 billion—basically the IMF, the World Bank, the ADB and some other Indonesian funds.

The assistance from other individual countries—a similar group of countries, although on this occasion the United States is also providing assistance—forms the third tranche. Indonesia has got their international reserves, which are about $20 billion, and then they have $23 billion from the international agencies. The support from individual countries is essentially a pledge to stand in the third row. When they publish their international reserves they effectively have all that as their holdings, although the third tranche would not be accessed except in the extremely unlikely eventuality that the first and second were all used. The Reserve Bank has no direct role through our balance sheet. Our contribution to Indonesia is essentially in the form of a pledge.

CHAIR—Could you detail what that pledge is?

Mr Macfarlane—The pledge is to come up with—

CHAIR—With a billion US.

Mr Macfarlane—With a billion US, as long as Indonesia is still adhering to all the rules laid down by the IMF.

Mr HOCKEY—So the first and second tranches have not been accessed yet?

Mr Macfarlane—I think there might have been a little use of the first, a tiny bit of the first, but not much. In Thailand's case all of the first, which is their international reserves, had been depleted.

Mr HOCKEY—So, in the case of Indonesia it is a confidence issue?

Mr Macfarlane—Yes, it is mainly a confidence issue.

Mr WILLIS—When you say 'come up with one billion US', is this as a loan?

Mr Macfarlane—Oh yes. No-one is talking about grants here at all.

Mr WILLIS—You did not say that. I just wanted to get that—

Mr Macfarlane—I am sorry. No. We are talking about either loans or pledges—which is not even a loan; it is an offer to make a loan at a later date, if necessary.

Mr WILLIS—If it was called on, it would be a loan with an interest rate attached?

Mr Macfarlane—Yes, indeed.

Mr WILLIS—Are there any exchange rate guarantees? It is US dollars.

Mr Macfarlane—Yes.

Dr SOUTHCOTT—Which country carries the exchange rate risk?

Mr Macfarlane—The only one that has been clearly worked out is the Thai one and Thailand carries the exchange rate risk. Thailand has to repay Australia in US dollars. We have no reduction. Because they carry the exchange rate risk, it is essentially a US dollar loan to them. We earn a US dollar interest rate and we carry no exchange rate risk.

CHAIR—Can we just clarify this Indonesian one? When are the details going to be worked out?

Mr Macfarlane—They are in the process of being worked out.

Dr Grenville—No, it is largely something that is happening in Canberra. We are not directly involved in the working out of those details.

CHAIR—Is Treasury doing that?

Mr Macfarlane—Yes, Treasury and Foreign Affairs will be doing it.

Mr PYNE—I have two questions arising out of your semi-annual statement on monetary policy. In that statement you make two comments with respect to South-East Asia. The first is that the reaction to the Asian crisis will depend very much on the reaction by the governments in South-East Asia to the challenges put to them.

The first question is: do you think the political will, specifically with respect to Malaysia, is there to do the things that are required in Asia to arrest this situation? And secondly, you also say in your report that Australia's participation in both these programs—being Thailand and Indonesia's packages—will help in quickly formulating these regional support packages.

We have suffered some criticism as a government in the last week, particularly from the member for Oxley asking the Prime Minister questions in parliament with respect to the Indonesian package. What response would you make to the criticisms that have been raised in respect to the Indonesian package?

Mr Macfarlane—Firstly, you asked me to enter the delicate area of Australian-Malaysian relations, and I will not, other than just to endorse the general comments made about the four countries. The speed with which they recover will be largely a function of how they can sort out their banking systems and some possible company failures and things like that. It is not really a function of how they handle the fiscal or monetary policy. I am assuming that they will handle that reasonably responsibly, as they have done in the past.

How do I answer the question that implies that we should not have done anything to assist Indonesia? My answer is that, just as in the case of Thailand, it is very much in our long-term interest to do so. As I said, the reason that the support packages were put together and agreed to by a range of countries was basically to stop a contraction turning into a rout. If we had a rout in one country and it had flowed through to another country, which it tends to do, the consequences for Australia would have been extremely severe.

We are talking about quarter per cents of GDP or half per cents of GDP, but we would be talking about very much bigger numbers than that even in the short run. And as for the long run, we all accept that it is very important that these countries get back to growing again as quickly as possible, and it is certainly in Australia's interest to do it. So I would not have any difficulty whatsoever in defending those decisions as enlightened self-interest, certainly long run self-interest and also short run self-interest.

Mr PYNE—Would you say that criticisms such as those that we maintained last week are naive and contrary to the national interest?

Mr Macfarlane—I think they are contrary to the national interest. Yes, I do indeed. I think there is a lot of confusion. That is why Ralph asked that question. A lot of people think that this money has been granted rather than being loaned. The other question that people are not aware of is that these are international reserves. They have to be held as international reserves. They are going to be invested either in New York, Tokyo, Frankfurt or in some other country. So whichever one of those places it is, they are essentially a loan.

When we buy US treasury bills, that is a loan to the US government. We are making a decision to change the composition of this loan and lend it to someone else to whom we think it is in our long run interests to do so and where we will earn a rate of return at least as high as the rate of return we have been earning to date.

Mr PYNE—You said in your opening statement that in some of these Asian countries there was an opaque relationship between business and government that had been not helpful. Do you expect that to change and, if so, how do you expect it to change?

Mr Macfarlane—I suspect that it will eventually change. It is something that has always been there. There are cabinet ministers owning parts of companies. There are governments telling banks they should lend to this industry because it is the favoured industry. There are all those sorts of things. It is not going to change overnight, but I think there will be a reduction in that in time.

CHAIR—The answers you have just given to Mr Pyne are very important to clarify on the public record exactly what it all means, because there has been a lot of confusion.

Mr McMULLAN—I want to ask a related question, but firstly, in endorsing your response to Mr Pyne, in terms ordinary Australians would understand we are talking about

tens of thousands of Australian jobs at risk. It is nothing less than tens of thousands of Australian jobs.

Mr Macfarlane—Yes.

Mr McMULLAN—You said in your earlier comments—and I did not follow it up at the time—that the real problem for Australia would be if the difficulties in the South-East Asian economies flowed through into North-East Asia. You talked about whether there was hard evidence of a link between these concerns in South-East Asia and the North-East Asian economies, which are much more important to Australia.

The concern that has been expressed to me, which on the face of it seems to have some substance, is that the evidence of that link lies in the Japanese banking system and its implications for the Australian economy if that were a profound adverse consequence could be more significant. It is something that needs to be dealt with rather sensitively, but I wonder if you can perhaps give us your response about the potential concern for Australia in that area?

Mr Macfarlane—Yes. We all express some unease about the prospect of economies such as Korea, for example, being affected. Korea has actually been going through one of these sorts of adjustments quite slowly for a couple of years. We are not going to expect the Korean economy to race away in the short run, but on the other hand we think that it has already done some of that adjustment. It has certainly done some of the adjustment on the exchange rate, although just how much it has done in terms of its domestic companies we are not sure.

The doomsday scenario people would bring Japan in, because we all know that the Japanese banking sector has experienced extreme difficulties for some time. Japan, of course, is our biggest customer and far and away the biggest economy in that region. I am not a member of the doomsday club there on the grounds that, whatever problems the Japanese banking system faces, it has been facing them already for five years. It is not as though they are up high on the top of a boom waiting to fall. They have already been down there for five years. They already had the adjustment in their asset prices back in 1990. The Nikkei was 39,000. It is now 15,000 or 16,000 and we have all heard the stories about the Japanese property prices which have come down dramatically.

The Japanese banks, whatever their difficulties, have had five years to make some progress. Now the progress might be slow, but my feeling is that they are in better shape now than they were five years ago. Because, even though they did not take the quick solution which the Anglo-Saxon type of countries took of getting in there and writing off the bad debts straight away, each year they have actually been making an operating profit and the operating profits have gone towards restoring their position. So, even though the rest of the world thinks they are not in great shape, they are probably in better shape than they were five years ago.

Mr HOCKEY—Specifically on the robustness of Japanese banks, Australia has a very good reputation for the quality of its financial markets and the quality of its financial institutions. Given the volatility in the region, does it provide Australian banks in particular, with any opportunities in South-East Asia?

Mr Macfarlane—It is a good question, because it is one of the ones I have not covered before in terms of what the effect is going to be on Australia. We tended to concentrate on trade and then we tended to concentrate on financial markets, actual financial prices. I would have thought it is possible that these events will have some positive spin-off to Australia.

One way that is quite possible is that Australia itself may well look to be a more attractive place to do business or to set up a business vis-a-vis some of these countries than was thought to be the case six months ago. I think people are not just looking closely at countries in terms of the sort of tax breaks they give you but looking at the whole infrastructure: what sort of infrastructure of commercial law have you got, what sort of infrastructure of accounting, what sort of infrastructure of bank supervision? How much transparency is there in the banks and the businesses? How can I judge what is going on around me? I think there may well be a lot of international businesses that would look rather more kindly on Australia than they would have six months ago. So there may well be some positive spin-offs there for us.

Mr HOCKEY—Does it also extend to the opportunities for Australian banks? Given the discussions about mergers between the main Australian banks and given that we have actually got quite a robust and efficient banking system, are there new opportunities in South-East Asia for our banks to take advantage of?

Mr Macfarlane—I do not know how I could answer that one. I would have thought there may not be a lot in the short run. I think there will be less appetite to borrow by the businesses in these ASEAN countries, so there may not be a lot of new business coming along there. I am not a commercial banker; I do not know. Maybe they can see opportunities that I have not seen.

CHAIR—Mr Macfarlane, I might just follow up on some comments that Mr Thompson made about five or six weeks ago when he was talking about his concern about declining lending standards. In the light of what you have just been saying and the questions, I would have thought that brings that into more stark question. Are you concerned about the lending standards and the general management of risks? Are you seeing a lessening of those standards in Australia at the moment and, if so, what would be the response?

Mr Thompson—The answer to that must come in two parts. The first part is that, on almost every objective measure you can find of the asset quality of Australian banks at the moment, the position is very strong. The ratio of their impaired assets to their total assets is less than one per cent, which compares with about six per cent five or six years ago. The rate at which loans are being classified as impaired or in doubt is very low and very stable. So our overall impression is that the asset quality position of the Australian banks is very strong. Their direct exposure to the South-East Asian countries is relatively small, so that assessment has not been affected by the events in Asia in the last couple of months.

The second part of the answer is that what we have been saying in a couple of places publicly is that we have begun to see some early signs of some sloppier practices creeping into lending to some parts of the market in Australia. Our objective has been to fire an early warning signal, if you like, about that trend. We are trying to look forward, to anticipate the emergence of problems rather than react after the event.

So the overall assessment is that the asset quality position of the Australian banks remains very strong—stronger than it has been for some years. But we have seen some slightly worrying trends in new lending practices and we have signalled a warning to senior managers in banks that they should be giving their attention to that area of their risk management.

CHAIR—Have you had any response, do you think, so far from banks?

Mr Thompson—Yes. I have actually been heartened by the number of bankers that have said, yes, they agree. They all say that it is not them, but they agree with the general comment that, under pressure of competition in lending to the top end of the market, and in some parts of the housing market, lending standards have deteriorated slightly over the past couple of years. In our consultations with senior managers of banks and in our on-site visits, we will be looking for signs of improvement in practices over the next little while, while we still have the task.

CHAIR—You say you will be looking for—

Mr Thompson—We are, progressively. Our visits to banks and our consultations with banks occur on a continuous basis. So we are raising that directly with banks in our consultations, and talking to banks about our impressions following our on-site visits to look at their credit risk management systems.

Mr WILLIS—If you see no improvement, what can you do? Would you advise me what you would do in those circumstances?

Mr Thompson—If we saw no improvement and we thought it was leading to a situation that was generally worrying, it is possible to adjust capital ratios, call chief executives and chairmen in for lectures from the governor—there are a number of weapons at our disposal. But I should emphasise that we are well short of being sufficiently concerned to be contemplating those sorts of responses. It is very much an early warning shot to try to head off any serious problems emerging.

Mr HOCKEY—Is that more a quality issue than a quantity issue? Is it more the quality of the assets behind it, for example, in the retail market and a housing mortgage, or is it more the fact that some banks are lending more money to individuals than they can really afford to repay?

Mr Thompson—It is not really either of those. It is a question of at the top end of the market the interest margins being extremely tight, which does not leave a lot of room to absorb any losses that might emerge in that lending. In some cases, it is the terms in the covenants that are attached to loans being less stringent and less rigorous than we were seeing two or three years ago. That might extend, for instance, to the sorts of conditions that a business borrower would have to satisfy in terms of other borrowings that the business could undertake, or the rate of growth of its balance sheet without providing additional security—those sorts of things. Those sorts of other conditions that are often attached to loans have just become a bit less rigorous in the past couple of years than we were seeing in the early 1990s.

Mr HOCKEY—Is that just a part of the competitive market?

Mr Thompson—It is. Of itself, it is the sort of thing that you would expect to see in a competitive market. What we are saying is, do not let it happen to the extent that you are exposing your capital and the interests of your depositors to the risks of those loans going bad.

Mr LATHAM—Does the bank believe that the current level of growth in household indebtedness in Australia is sustainable?

Mr Macfarlane—The current level of growth, in a sense, is not, because if you extrapolate forever more—

Mr LATHAM—How much further can the level grow before it would be a concern?

Mr Macfarlane—We have a little graph here in the half-yearly. We do not know much more about it. The international comparison is contained on page 17. You are right, Mark, that the rate of increase has been very sharp, that it brings us very close to the levels of the UK, Japan, and the US, having been really quite low in the mid-1980s; the Australian household sector was extremely cautious and prudent in the mid-1980s. Part of the increase there, of course, is low inflation, low interest rates, increased capacity to borrow. It is possible to responsibly run a bigger debt position in a low inflation environment, more so than it would have been in the mid-1980s, which was a higher inflation and, more particularly, a higher interest rate environment.

But it is something to look at, and we have started to do a little bit of preaching on this. We cannot do anything more than preaching. We certainly would be worried if a lot of households were still borrowing on some of the assumptions that they have traditionally had, that inflation and a rapid increase in their earnings will mean that the repayment burden whittles away very quickly, because repayment burdens are not going to whittle away that quickly. They will whittle away, but not quickly anymore.

CHAIR—We might come back to this question of supervision when we talk about some of the other developments. The deputy chairman has been very patient. He wants to raise some specific questions on wages, I think, so we might let him loose.

Mr WILTON—I put to you a couple of questions along these lines when we last met in May. I guess I am hoping for a bit more of a definitive answer on this occasion. At that time, I had suggested to you that the RBA's comfort zone for full-time AWOTE growth had an upper limit of 4½ per cent. As you put in your semi-annual statement, the annual growth rate for this series has been up to about 4.1 per cent—certainly between 3.8 per cent and 4.1 per cent over the last 18 months.

In your view, what is driving AWOTE growth to these levels at this time? In particular, how much of it is accounted for by, for example, the $10 living wage decision? How much of it is accounted for by enterprise bargaining settlements? You have cited in the document that executive salaries are still growing at a stubbornly high six per cent. How much of it is accounted for by that increase in executive salaries?

Mr Macfarlane—You are getting very technical here. I do not know that I will be able to satisfy you with any great degree of precision. We say here that the previous safety net adjustment has not had a big impact on that figure. We show a figure here for enterprise agreements and, unfortunately, the average there is still probably sneaking up a bit. It is below five but, on average, it is sneaking up.

On the other hand, there are some encouraging signs as well. There are some enterprise bargains which, in the first round of the enterprise bargain, were a bit over-ambitious. Both parties to the wage bargaining process were assuming higher inflation. There were some enterprise bargains that were five or above which, in the second round, are now lower. The classic ones are the banks' enterprise bargains. I think it is also true for some of the enterprise bargains that have occurred in the manufacturing sector where they had bigger increases in the first round and smaller increases in the second round.

Whilst the average, according to this, is probably still going up as some firms who are doing their first enterprise bargaining are added, at the cutting edge, the pacesetting edge, the enterprise bargains are coming off a bit and both sides of the bargaining process are recognising that they are bargaining in a world where underlying inflation is two-point something and, unless there are some exceptional circumstances, you cannot keep assuming that you can increase wages at five per cent.

If you do increase wages at five per cent in that environment, you are limiting the amount of new employment which is going to go on, particularly in manufacturing. You say to the manufacturers, ‘Why did you so readily agree to a five point something or other enterprise bargain when you are living in a world where not only are your output prices lower but they are not even rising at 2½ per cent and, in many cases, they are almost zero per cent?’ Management says, ‘The thing that worries us is not the wage rate per person but the wage bill,’ and that they can keep the wage bill down by reducing the size of their work force. That sort of environment is not conducive to employment growth and low inflation but, more particularly, the big loser there is employment growth.

Maybe I am being overly optimistic, but I think that was a sort of teething problem as people were adjusting to the new system. On either side they have not come from a culture where there has been a lot of enterprise bargaining, and of course their experience of inflation has been so heavily conditioned by what happened in the 1970s and 1980s. At the cutting edge, I think the more experienced workplaces are starting to move towards more realistic results.

Mr WILTON—What other significant influences would there be on AWOTE? Could I draw your attention to three that you might like to make a comment on? The first of those would be compositional change; the second would be the propensity for individuals or groups of individuals during the course of enterprise bargaining, for example, to cash in, as it were, penalties, and the third is a limited one on the introduction of a federal minimum wage.

On the issue of compositional change, I recall reading a press release of yours just after we last met which announced the interest rate cut when you said, in regard to AWOTE data, that public sector figures, and hence total figures, are almost certainly overstated by compositional distortion.

Mr Macfarlane—We do. We think the public sector ones have to be because the average has gone up faster than any of the known components, and part of that then flows through to the total. We have conceded that with the AWOTE numbers there are probable overstatements. I think I referred to that earlier when I said even before the May meeting we were conscious of the fact that we thought there were probable overstatements. It does not sound very convincing for the central bank, having said 4½ per cent is the upper limit, as my predecessor said, to then, a week after the upper limit is breached, go and ease monetary policy on the ground that we had a few private misgivings about the quality of the statistics. Now that the statistics themselves have been revised we feel more confident that these things are in a reasonable corridor.

I do not know that there is all that much more that I can really say at this stage other than, at the moment, they are in a reasonable corridor, and I think there are some encouraging signs that the enterprise bargains are becoming more realistic.

Mr McMULLAN—I might ask a subsequent question about the labour market following on from an earlier comment that the governor made. Have you sought to measure the actual impact of the last living wage claim outcome against your expectations of what it would be in terms of the comments you made at that time? I notice you say in the statement that it has not been large.

Mr Macfarlane—I am not aware that we have. We did do an internal measurement of the ACTU claim last time. I do not know—we may well have but I, myself, cannot speak to it—whether we have then gone ahead and done an internal estimate of the likely effect of the decision and compared it to what the actual numbers suggest. I am not even sure whether that would be possible to do that.

Mr McMULLAN—I understand there would be some difficulties because some of the things assumed about absorption, et cetera, are capable of some degree of after-the-event assessment. I do not want to ask another question, but I would suggest that it might be useful, to the extent the bank is able, that it might do that. It might inform people's assessment of your next analysis.

I want to follow up a question that the deputy chair asked. You have responded very comprehensively now to two parts of it. He was talking about the relative importance in AWOTE of the five per cent or so increase in enterprise bargaining, and you have given a comprehensive response to that, and he referred to the impact of those who get increases only through the award system, and we have discussed that. In the Cullen, Egan and Dell figures, which you quote again, showing the six per cent increase in executive salaries, have you sought to assess how significant a component of AWOTE that is? Initially people used to say it is large, but it is not significant, because there are not very many people. I am not sure that is any longer the case. I wonder if there is any assessment of that.

Mr Macfarlane—We have not done an assessment, but I think you are right. We should do an assessment. I have always assumed, the same as you have, that the proportion of people covered was very small and so it would not have much of an effect on the aggregate. It would be interesting to spend some more time looking at it. It would also be interesting to look at whether the fastest rates of increase within that correlate with those people working in firms that have been spectacularly profitable or whether some of it has been earned by people whose firms have been less than spectacularly profitable.

Mr McMULLAN—I very much recommend to you that piece of research and one other, which sees some correlation between people who urge other people's wages to be cut and their own income. That was not intended as a reflection on the bank, but on a large number of independent commentators, whose enthusiasm for cuts in wages never seems to apply to themselves.

That goes to the key question of the burden of restraint. I accept that, as a nation, we are better off with low inflation outcome. Low income earners are beneficiaries of that as well as other Australians. But isn't this the circumstance we are coming to, to some extent influenced by your advocacy at the time of living wage cases, that for the people on the highest incomes (who tend to be those on executive salaries and then, in descending order, those who get their increases through enterprise bargains)—that the better they do, the greater is the level of restraint imposed on the people on lowest incomes, the people who get their increases through the award system? Isn't that the system we are coming to now?

Mr Macfarlane—I do not know whether we are coming to that system. It is perhaps a question that would be better addressed to the commission.

Mr McMULLAN—Sure.

Mr Macfarlane—I think there is always a tussle between wage increases and employment, in the manner that I described before, when employers look at the wage bill. The idea of a tussle between those sectors whose wages grow very rapidly, leaving leftovers for the others, seems to me an institutional argument. It is an argument about how the commission makes decisions rather than a purely economic argument. Those minimal award wages are determined institutionally.

Mr McMULLAN—I just want to go to the labour market question. It goes back to your comments about the snapshot at the end of a 30-year period of the relative United States and European labour market situation. I accept that it is an accurate description of the circumstance in November 1997, but if we had taken the same snapshot around 1992, when we had 25 years where growth was comparable in Germany and the United States, the labour market structures were pretty much as they are now. As I recall the figures, that snapshot would have proved that unemployment was significantly lower in Germany than in the United States. If the thesis is accurate today, it ought to have continuing effect.

I do not have a 30 year-average but over the 10 years to 1996, as I recall the statistics, unemployment averaged in the United States and Germany was almost identical. If measured out of a snapshot of November 1997 there was a factor of enduring relevance in terms of the relationship between those structures and those unemployment outcomes, it should show up more than just at one point in time. It should show up consistently both in the averages and at different points in the cycle, not just this point.

Mr Macfarlane—My recollection of the statistics is somewhat different to yours, although I do concede that the really big differences between countries like the US and the countries of continental Europe have really shown up during this decade. It is really during this decade that the US has done spectacularly well and the continental Europeans have done very badly.

Part of the reason it took until this decade was that some of the continental European countries were living on borrowed money. Sweden is the classic example. It was not until they eventually reached a budget constraint where they could no longer fund all the jobs on the public payroll, because they virtually ran out of money, that the unemployment situation deteriorated quite quickly during the 1990s, having been held together during the 1980s.

The other thing is that I am talking about the continental European countries in total. Germany is a bit different because of unification too.

Mr McMULLAN—I do not have the data for that.

Mr Macfarlane—The German figures do look as though they have shot up quite quickly towards the end because, once they brought in East Germany, they rose. I have not got the numbers here, so maybe we can talk about it later. My feeling is that, if you take continental Europe as a whole, you do not have to rely just on the second half of the 1990s. Certainly in the early 1990s—and probably even right at the beginning of the 1990s—you were already starting to get the message coming through. The straight US-German one may be like that because of the effect of Germany unification.

Mr HOCKEY—Probably the most significant small group of employers in Australia remains the six states and two territory governments who between them employ over a million people full-time. In Australia we have developed a political cycle of timing so that over the next 24 months all the states will be going to elections. On precedents, it seems that there is always a round of industrial disputes in the lead-up to elections and the political cycle is in some ways linked to the wage claim cycle. Do you have a view about the recent approval by the New South Wales government of a 6½ per cent annual increase in salaries for 16,000 police and the ramifications of a decision like that and of that type of outbreak in the public sector.

Mr McMULLAN—Be very careful driving home tonight.

Mr Macfarlane—I cannot comment on the particular decision concerning the New South Wales police—not through fear but just through ignorance on my part. I have heard the suggestion made before that state governments give generous wage settlements if they think an election is coming on.

Mr HOCKEY—We know they give generous wage settlements.

Mr Macfarlane—But this cannot be the first cycle we have had during the 1990s.

Whatever the last cycle was when there were a whole lot of state government elections, we managed to get through that okay without a huge wage blow-out. I am assuming that the same thing will happen on this occasion. It may be there will be some key public sector decisions which we will have to watch, hoping that they do not spill over, but I cannot comment specifically.

Mr LATHAM—Earlier you mentioned the bank's caution on the wages front, for historical reasons. At the last hearing I think you mentioned that you are still learning as you go with the more decentralised wages system. Do you think there is an argument—just looking back at the last 12 months—to say that the bank went a bit too hard in its opposition to the living wage claim? You have inflation a full percentage point below the average you are seeking. On top of that, I would have thought there was a social equity, social responsibility argument to be considered in these compositional questions as well.

The ACTU has estimated that the six per cent executive salary increase has the same impact on overall wages growth as the $10 living wage increase. The difference is that the executive salary increase goes to 75,000 Australians and the living wage increase goes to the two million lowest paid Australians, who are mostly people locked on minimum rates who would not otherwise have a chance of productivity based improvements. Do you think the bank has some social responsibility to enter into those equity arguments, given that there seems to be a concentration of increases for some Australians and it has exactly the same impact on your wages concerns as this major equity concern at the other end of the scale?

Mr WILTON—I would like to add a third part to that question. Given that inflation has plummeted since last April's living wage decision, and given the bank's outlook, as Mark said, why would a $20 outcome not be affordable at some stage next year?

Mr Macfarlane—I am not going to comment on that one, because I have not done the arithmetic. On the general issue of whether we went too hard, I do not think we did go too hard. Basically what we said was that there was a corridor for aggregate wages which they should stay within. We did cost the ACTU claim, and we said that was too high. The decision was made by the commission.

I still think that the way we handled it was correct. We did not appear at the hearings or anything like that. We did not claim to be experts on the arithmetic. In fact, we had to become bigger experts than we were because the ACTU challenged us to put our arithmetic down, and so we ended up putting it.

We do not claim to be able to nominate what rate of increase each of the particular channels that go to make up the aggregate figure should be. We have not got any power or responsibility in that area. For many years we have drawn attention to the fact that executive salaries have increased faster than we believe to be consistent with inflation and productivity. We will continue to do so. But we cannot specify the rates of increase for the enterprise bargaining stream, the award stream or the executive stream. The other stream that none of us fully understand is the residual that I have not specified. That is where a lot of the action is.

Mr LATHAM—Would you like the parliament to explore some ways of achieving executive salary restraint in Australia?

Mr Macfarlane—I do not think I could comment on that one.

Mr LATHAM—You told the commission that you are happy to see the lowest paid Australians not receive the increase. Surely you must have a view about what parliamentarians should be doing at the other end of the scale?

Mr Macfarlane—We did not say that they were not to receive an increase. We were saying that a particular claim that was made was too high. That is what we said.

Mr LATHAM—But you have no view on executive salaries?

Mr Macfarlane—That was a much bigger claim than six per cent.

CHAIR—I do not want to debate the issue. Given the time, we might move on. I would like to get back to financial surveillance. Maybe we could kick off with your response. I know you have done questionnaires and so on, but what is the current state of play with banks' preparedness for the year 2000?

Mr Macfarlane—Here on my right is the undoubted expert on this.

Mr Thompson—In a nutshell, they have made a start on fixing the problem but they have a lot of work to do. Our assessment from our survey responses is that there is still sufficient time, given where they are, to sort out solutions to the problem before the date.

CHAIR—Are they moving fast enough?

Mr Thompson—We would be happier if they were moving a bit faster, but by and large they have adopted the generally endorsed target of having the systems year 2000 compliant by the end of 1998. That allows a little time for slippage if they are not successful in meeting that. It is not something that we are overly concerned about at this point, but it is something that we will certainly be keeping on at them about over the next year or so, to make sure that they continue to work and devote the necessary resources to it.

From a commercial point of view, they have every incentive to do exactly the same thing. It is not really something that we should have to crack the whip about. It is in their commercial interests to sort out the problem.

Dr SOUTHCOTT—I understand it is a goal of the Reserve Bank to make the decisions of the board more transparent. This relates to an earlier question from Mark Latham. Has the board considered making decisions—or not making decisions—after their board meeting, as the US Federal Reserve does? Secondly, what mechanisms does the board have to deal with conflicts of interest, where they may arise? Do members at board meetings raise whether there is a conflict of interest and do they absent themselves from voting? Have you considered adopting another procedure of the US Federal Reserve, in having the minutes of board meetings published?

Mr Macfarlane—There are three questions there. I am not sure they are all that closely related. The first one is whether we have considered only making our changes the day after board meetings. We have considered that. We have thought about it, but we have never made that a policy. I have some figures here, and I think that on only eight of the 23 occasions we have announced monetary policy changes has it been the day after the board meeting. There is a belief that we always used to do that and have recently changed. That is not the case. We have never really done that. There has never been a formal—or even an informal—commitment to do that. We make the change when we think the conditions are right.

When you talk about the policy of the United States, that is very recent. The United States never used to announce policy changes. It is only in the last two years that they have moved to a system of announcing policy changes. One of the influences on them was the Reserve Bank of Australia's practice of announcing policy changes. The US has only been doing it for two years. My feeling is that they will not stick to that record in the long run. Something will happen. I cannot foresee what that might be, but something will happen at some stage and it will be in their interest to make a change. If something happens a week after the Open Market committee meeting—those are six weeks apart—it will be in their interest to do something straightaway rather than wait for another five weeks before they do it. I do not know what that will be, but I believe that will probably happen in the long run. The main point is to let you know that this US policy is actually a very recent one that has not really been put to the test.

Dr SOUTHCOTT—Given that unforeseen circumstances can always rise and sometimes there can also be mechanical problems—governors and deputy governors can be out of the country and so on—would it be a useful goal to have that sort of ideal: to aim to announce the decisions after a board meeting?

Mr Macfarlane—I do not think so. There was a time when we got close to thinking that, but practice never reflected it. There was a time when we were trying to establish in the public's mind that it was the Reserve Bank board that was making the decisions. For a time we tried to put it very close to those meetings whenever we could. But we never really made it a firm practice.

For example, in December last year, we were going to ease. That evening the exchange rate went down 300 basis points. There is no way you can responsibly do that next morning when you have just seen that happen. We had to sit back and wait for a week. Then, when everything had recovered, we went ahead and did it. We would just be making difficulties for ourselves. Any gain in predictability would be very minor. The losses would be greater.

CHAIR—There were two other points I think. You were going to answer those two other points of the question.

Mr Macfarlane—Yes. Just prompt me again on what they were.

Dr SOUTHCOTT—What mechanisms does the board have to deal with conflicts of interest? Have you considered having the minutes published?

Mr Macfarlane—We do have mechanisms that deal with conflict of interest, but no mechanism can ever deal with conflict of interest perfectly. Essentially, once you make the decision to have lay board members, as we have—we have four 'monks' from the official sector and up to seven lay members who represent private sector academics, et cetera—you know there is potentially going to be a conflict of interest, because the sorts of decisions that are made affect the whole economy. They affect the cost of borrowing money and the exchange rate and all the rest. So it is going to be there.

What we have is, essentially, a number of mechanisms—imperfect though they are. You cannot be on the board if you work for a financial institution or have a directorship of a financial institution. When you come on the board, you also have to sign a declaration of secrecy. It is a declaration we think all honourable people would adhere to, but no-one can be 100 per cent sure. Every board member has to notify us of any commercial involvements they have—any directorships or what have you—and they have to keep us updated. They have always done that. We have never found ourselves in a situation where we have been discussing something and someone had a connection that we were not aware of.

That is basically the set of arrangements that we have, which is not all that different to the arrangements that you would have in a private company board. I think it is almost the same—in fact, more so because we have a declaration of secrecy, which may not necessarily apply there. The central issue is that, if you want to have lay members on a board, you are going to have to put up with a certain risk of conflict of interest.

Dr SOUTHCOTT—What about publishing minutes?

Mr Macfarlane—Historically, the only people who have ever been interested in minutes—elsewhere they are usually published six or eight weeks after the events, as the Fed does—are academics who want to write theses on various things. I do not think they are anywhere near as valuable in terms of keeping the public informed as publications or committee meetings like this. I think these are much better than carefully worded minutes.

I do not know whether you have ever read any of the minutes that are published, but they basically sound like a small version of this, except they are six weeks out of date. They do not typically say who said what to whom or what argument someone put forward. The problem is, once you start doing that, you just get people playing to the gallery rather than doing what they think is right. It is a possibility, but it is not a very big issue in my view.

CHAIR—They would show votes, for example, if there were a split decision.

Mr Macfarlane—Yes, and as a result there is very rarely a split decision.

Mr ALBANESE—I want to take up the issue of the board's decision making processes, particularly in relation to the gold sell-off. Given that there were press reports post that decision claiming that some market participants had been told by reporters before the embargo was lifted on the press release you put out announcing the decision on selling gold, in retrospect do you consider that it was appropriate for the bank to issue such sensitive market information by the way of an embargoed press release?

Mr Macfarlane—You are getting a bit technical here. Let me go through this. Basically, the gold was sold six months before the announcement that we had done it. We put out a press release that had an embargo on it. A lot of our press releases have embargos on them. The *Bulletin* has an embargo on it.

You put an embargo on something because you want to give the journalists who are going to transmit it to the wider community time to fully digest it rather than having to blurt out a very quick assessment, particularly with the wire services where they are going to want to put the information out within a second or two of receiving it. So if you embargo it, you give them an opportunity to read the thing fully so that, when the time comes, what they put out reflects a full reading of the document.

You always take a risk I suppose. I was not aware that any of the journalists had broken the embargo. I am sorry, but you are implying that they did?

Mr ALBANESE—The *Sydney Morning Herald* reported on 7 July that in fact that had happened.

Mr Macfarlane—Steve just pointed out to me that, if the embargo had been broken and someone had taken advantage of it, the price would have moved. The price of gold did not move until the embargo was lifted. Our judgment would be that, even if someone had heard it, no-one had taken commercial advantage of it.

Mr ALBANESE—Did you anticipate such an adverse market reaction to the announcement?

Mr Macfarlane—We expected there would be some fall, but we did everything we could conceivably do to minimise it. For example, the main thing we did was that we only told people about a past event—that is, our sales—and said that there would not be any future event. In other words, we did not give them any forward information about anything that was going to affect the demand or supply of gold because everything that was ever going to be done had already been done.

The Swiss, for example, as you are probably aware, have come up with about six or seven different announcements already about what they are going to do in the future. We think that that sort of thing is very unsettling, so we tried to minimise it by making sure that there was no forward looking information in what we said. All we had done was to confirm something that had already happened.

Mr ALBANESE—In terms of the timing and the way that the announcement was made, did RBA make that decision or did it make that decision in consultation with the Treasurer?

Mr Macfarlane—I cannot remember. It seems to me highly likely that we did it ourselves because we put embargoes on a lot of the things we put out. It is not uncommon for us. As Graeme points out, the crucial thing about the timing, and the fact that it was the first week of July when the announcement was made, was determined by the fact that delivery took place in June—even though the sales had been made earlier—and so the July statement of our international reserves would reflect the lower level of gold holdings, so we had to make the announcement at exactly that date. We had no choice in that sense.

Once we had sold it forward many months earlier, it determined for us that the announcement would have to take place in the first week of July. Of course, it was unfortunate that the first week of July was not a very good week because the gold price was already weakening and had reached its low point for the year during that week. The market was in a nervous state of mind when our announcement came out and that was very unfortunate, but we had no choice in the matter.

Mr WILLIS—Just on that issue, as you know, when the announcement was made the price plummeted from about $332 to $312 virtually straightaway. It has bounced around, but it has remained pretty much at that lower price. There was a lot of criticism from the gold industry and there have been announcements of various closures of goldmines, postponements of expansion plans, et cetera. When you were considering what you said was being done in the national interest, how much consideration did you give to the national interests of Australia as a major gold producing country and the impact that your decision to get out of gold might have on the world gold price and, therefore, on a major export industry of the country?

Mr Macfarlane—Can I go back to those figures. The price was $332 when the announcement was made. It went down to $317 and then came back very quickly to $320. In fact, it has since been above $332—this is US dollars per ounce. It has actually come back and has been higher than it was when we made that announcement. It is certainly true that in the two days after the announcement the price went down a long way.

The other thing I want to point out is that the Australian dollar price of gold is higher now than when we made the announcement. The Australian gold producers are getting a slightly higher return per ounce of gold than they were immediately before we made the announcement.

Mr WILLIS—But in terms of the impact that you might have on the gold industry, did you factor that into your considerations of what is in the national interest?

Mr MacFarlane—Yes.

Mr WILLIS—The gold industry, I think, felt as though—and they made this very clear—they had been let down by the central bank in the sense that Australia is not like the Swiss, who do not mine and produce gold, but we are a major gold producing country. If we, as a major gold producing country, were getting out of gold then that sent a quite different signal and had a greater an impact on us than on a country which is just holding gold because they see some value in doing so. Therefore, the market ramifications were likely to be more substantial and there was a much bigger prospect of there being an adverse economic impact on Australia.

Mr Macfarlane—We certainly did take that into account in our decision but our view was that in the long run the price of gold would go where the price of gold was going to go and the decision on our relatively small amount of gold would not have a long run influence on the price of gold. It would have a short run influence—and in fact it turns out it had a bigger short run influence because of the nervous nature of the market in that week—but in the long run, the price of gold would not be influenced by what we did.

Mr WILLIS—What did we get for the sale? What was the return on the 167 tonnes?

Mr Macfarlane—The main return is the fact that each year the taxpayers were forgoing about $150 million a year because they were earning no return on it. That was the main recurring cost of holding the gold.

Dr SOUTHCOTT—Has the sale given more flexibility to participate in the sort of currency swaps that we have had in Thailand and Indonesia for your foreign exchange reserves?

Mr Macfarlane—At the margin, yes it has. Anything that means you are holding more liquid assets in your international reserves does give you that. Gold is not a particularly liquid asset in that sense.

Mr ANTHONY—Moving away from gold and wages in Asia to the payment system, there is obviously a lot of disquiet still from the community, notwithstanding that there is a process to get faster clearance, from five days down to three days, some time next year. Are you satisfied that there is sufficient progress being made to reduce that clearing time? Should it be faster, particularly in the light of your moving towards real-time growth settlement for larger transactions? Should there be greater pressure, which perhaps you could lead, for the banks to have a faster clearing process?

Mr Macfarlane—We are finally getting some progress there and in fact the progress has really only been announced in the last week. It has taken a long time, but I think there is some progress. Maybe, Graeme, you could explain the recent developments there.

Mr Thompson—The banks have committed to a timetable to reduce cheque clearance times from what is effectively a five-day clearance now to three. Three actually means 48 hours. We count day one as the day on which the cheque is deposited and the cheque should be cleared under these new procedures by day three, which would in fact be 48 hours after the cheque was deposited.

I think we all are of the view that it would have been better if the banks had got on to this earlier. But from where we are now, I do not think it can be done much more quickly than the timetable that they have committed to. It is quite a complex business to arrange all of the electronic linkages between the banks and those linkages will need to be tested extensively. I think we have come a good way in that the banks now do have a public commitment to a timetable to give cheque clearance in a time which would be up with world best practice. I think it is unfortunate they did not get started sooner.

Mr ANTHONY—Is that the middle of next year?

Mr Thompson—They will need to have the technology in place by the middle of next year for it to happen but, following that, there will need to be a period of phased implementation and testing. It is likely to be early in 1999 before day three clearance is fully available.

CHAIR—Okay, we might move on to the Wallis inquiry as I see the time is going to get away from us. When you came before the committee in May, I think your comment was:

If we are very serious about taking responsibilities for system stability, we would probably need to almost be a second bank supervisor.

Since then, of course, the government has taken a decision for a prudential regulator. In the light of the government's decision, do you still feel the same way about that in terms of giving that supervision?

Mr Macfarlane—The members of the committee will be aware of the fact that the Reserve Bank, in its submissions to the Wallis inquiry, argued against that change in the regulatory structure. We argued in favour of us retaining bank supervision but the decision has been made and due process has been followed. The government had an inquiry, the inquiry reported and it favoured a different model; it favoured the model of having a separate bank supervisor to the central bank. The government has accepted the recommendation of the inquiry. The opposition, as I understand it, also supports the recommendation of the inquiry. As far as we are concerned the umpire has made the decision and we will fall into line and go along with that, and do our best to make sure that the new system works as well as it can possibly work.

That means, from our perspective, that the new prudential regulator, APRA, has to be an absolutely first-rate organisation. We will make whatever contribution we can to making APRA into a first-rate organisation because we will depend very much upon it and the community will depend very much upon it. As we have seen from our discussions of other countries, much of the economic disturbance in the modern age comes through disturbances to the banking sector. If they occur on a big enough scale they pose systemic problems, and systemic problems are very serious because they always end up involving deep recessions or depressions.

It is absolutely essential that the new model works extremely well. It can work well; there is no doubt. There were always two basic regulatory structures: one which had bank supervision in the central bank; and another one, which a number of countries had followed, which had bank supervision outside the central bank. The system can be made to work well if APRA is a first-rate institution, and is staffed by first-rate people, and can get operating reasonably quickly so there is not too much of an interregnum between the two systems.

CHAIR—In terms of systemic stability, though, what additional role would you see for the Reserve Bank?

Mr Macfarlane—The one that is easy to put your finger on is the payment system. Our powers over the payment system that we retain will, in fact, be enhanced as a result of the government's acceptance of the Wallis inquiries. The other thing that we have to do is have an input, and we will, into how policies are designed—policies that influence the stability of the financial system. No individual country these days has much influence over a large part of those policies because we all adhere to the Basle capital requirements.

To a large extent there is a mainstream body of policy which is really international in nature.

But, at the margin, there are also a lot of other policies which will have an influence on how prudent and stable the banking sector will be. Obviously, through our membership of the board of APRA, we will have to have an influence on those. In order to do that we will want to have a pretty good understanding of what is happening, not just in banking but in the interaction between banking and financial markets, which is something which we are working in every day, so it should give us a reasonable chance of having that. We will have our own views about where the pressure points in the economy are and we will want to know where the risks are. We will be talking to people but we will not be doing one-on-one supervision of individual banks. That will be done by APRA. If a bank has a change it wants to make, it goes to APRA; it will not come to the Reserve Bank as it currently does.

CHAIR—In terms of maintaining the stability, would you favour the opening up of the payments system first, rather than at the same time as changing the regulation?

Mr Macfarlane—The payment system issue depends very much on how rapidly you want to make changes there. The Reserve Bank will have responsibility for how rapid those changes are. We certainly would not want to be taking huge risks. We are going to want to be making sure that we have a payment system which is not only efficient but also extremely sound. That will have some influence on what sort of institutions can enter the payment system.

Mind you, there are plenty of institutions that are already in parts of the payment system which are not banks or do not have bank accounts with the Reserve Bank. A company like American Express has been in the payment system. It has been a particular part of the system for decades. The store card that you get when you go to a major retailer is part of the payment system, but it is not a bank and it does not have a relationship with the Reserve Bank.

A lot of parts of the payment system are already open and contestable, and they will remain open and contestable. But, if people or institutions want to come to the absolute core of the payment system, which is the settlement process which involves having an account at the Reserve Bank, we will be the ones who make the judgment as to whether they have the financial stability and the required prudential practices to get into that.

We will be conscious of the fact that changes are occurring in the payment system at the same time as changes are occurring to who is the bank supervisor.

CHAIR—So you would therefore be trying to manage it.

Mr Macfarlane—Yes.

CHAIR—Which way first?

Mr Macfarlane—They are going to happen simultaneously. I do not think there is an option to do one and then do the other.

Mr Thompson—A lot of things are going to happen pretty much at the same time. That puts a premium on them being managed carefully.

As far as the payment system goes, I do not think we have any serious concerns. What is proposed is not a free-for-all. As the governor says, the Reserve Bank will retain control over who has access to the core of the system, which is the settlement system, and we will acquire new regulatory powers in relation to the payment system as a result of the Wallis recommendations that we have not had in the past.

The other development is the introduction of the real time gross settlement system which will, when it begins operating in April next year, take a large slice of inter-bank settlement risk out of the system because those settlement exposures will be settled continuously rather than on a deferred basis as they are now. We are not concerned.

CHAIR—So on balance are you saying that the risk will be less, more, similar?

Mr Thompson—Inter-institutional settlement risk in the payment system will be considerably less under real time gross settlement than it is under the present system, which is the whole reason for introducing the RTGS system.

Mr Macfarlane—Of course, that is something that has happened outside Wallis, that is something that was happening anyhow.

CHAIR—Does that include new players coming in?

Mr Thompson—People who have settlement accounts with the Reserve Bank can participate in the RTGS system. The extent to which new players are involved in the RTGS system comes back to our policy decisions about who can have settlement accounts with the bank.

Dr NELSON—Mr Macfarlane, I would like to take you back to the threats to our growth forecasts. We have talked about the Asian currency and equity problems and you mentioned El Nino in your introductory remarks. However, to what extent is the bank concerned about the outcomes in Kyoto in December? Whatever the outcome, it is likely to have a significant impact on Australia’s growth and employment forecasts. Have you been doing any work on it, or any analysis of the reports that have been made about the likely impact?

Mr Macfarlane—I have to confess we have not done anything on that. We have assumed that any influences would probably be long run rather than short run. Of course, we would be only too happy to see any work that others may have done on this subject, but we have not done any ourselves at this stage.

Dr NELSON—So the bank does not have a view at all on the position that Australia should be adopting in relation to it?

Mr Macfarlane—No, we have not taken a view on that.

Mr WILLIS—I have a sort of theoretical question, just so we understand how the inflation target works. Let us assume that, in looking forward from here, you did not see the inflation rate coming back into the two to three per cent band, say, by the end of 1998. Does that imply in those circumstances that you would therefore move to reduce interest rates again? If you have an inflation target and you are going to remain outside it for a long time, does that actually imply that you ought to be moving back into that band and that therefore you need to further reduce interest rates or is it a benign situation to remain below the band?

Mr Macfarlane—No, you are right, Ralph: the situation is symmetrical. Other things being equal—unless there was some disturbance going on somewhere else—a prolonged undershooting would be a signal to reduce interest rates. In fact, that was a very important part of the last two easings of monetary policy in May and July.

CHAIR—That must have been an important statement, too. I would like to thank everyone very much indeed. I thank the governor and the deputy governors very much for coming along for what has been another marathon session. I thank all the members of the committee—I think we had all bar one here for most of the time. I thank all those from the media who turned up to make sure that this is well and truly publicised.

Resolved (on motion by Mr Hockey, seconded by Mr McMullan):

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

Committee adjourned at 1.57 p.m.