HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

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

MELBOURNE

Thursday, 7 May 1998

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 Martin	

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

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

WITNESSES

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000 61

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000 61

THOMPSON, Mr Graeme John, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000 61

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reserve Bank of Australia's annual report 1996-97

MELBOURNE

Thursday, 7 May 1998

Present

Mr Hawker (Chair)

Mr Anthony	Mr Mutch
Mr Causley	Dr Southcott
Mrs Gallus	Mr Willis
Mr Latham	Mr Wilton

Committee met at 10.31 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. This is the third occasion that the Reserve Bank has appeared before the committee under the agreement between the Treasurer and Governor on key aspects of Australia's monetary policy framework. Also at the basis of the committee's investigation is its examination of the Reserve Bank's annual report as part of the committee's examination of annual reports within its area of portfolio responsibility. This takes place under House of Representatives standing order 28B(b). These hearings have always proved popular with the financial sector, the community and the media. I am pleased that there is good media representation here today.

This hearing provides an excellent opportunity for the parliament, the financial sector and the community to monitor the way in which the Reserve Bank conducts its activities and monetary policy and the basis for those decisions. These hearings have become an important element in the bank's accountability and transparency processes. The committee's November hearing came in the early stages of the awakening of the Asian currency crisis. There was little concrete data available at the time which made it difficult for anyone to make predictions on the impacts. At this hearing we are looking forward to hearing the more considered views of the Reserve Bank on this critical matter. Today's hearing will cover both monetary policy and prudential matters.

On behalf of the committee, I would also like to congratulate Mr Thompson on his pending appointment as the Chief Executive Officer of the new Australian Prudential Regulation Authority. We are pleased that he is at this hearing today in his capacity as Deputy Governor of the Reserve Bank until the new authority is established. We will probably have some questions for him on his new role too.

As we have a lot of material to discuss with the Governor and the Deputy Governors, I call and welcome today the representatives from the Reserve Bank of Australia. I remind you that the evidence that you give at this public hearing is considered to be part of the proceedings of parliament and I therefore advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament.

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000

THOMPSON, Mr Graeme John, Deputy Governor, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales 2000

CHAIR—Mr Macfarlane, would you like to make your opening statement before we proceed to questions?

Mr Macfarlane—Thank you, Mr Chairman, I would like to continue with the practice of making an opening statement. It is a pleasure to be in front of your committee again under the new arrangements set out in the statement on the conduct of monetary policy. I hope this meeting will be as successful as its predecessors in helping to lift the level of understanding of monetary policy, financial stability, the Australian economy, and of course, the region more generally. I also hope that you have found our *Semi-Annual Statement on Monetary Policy* to be a useful source of information and a reasonably clear statement of our views.

It is especially pleasing that we are meeting in Melbourne for the first time. If you remember, the attempt to do so last November was foiled by a clash with Melbourne Cup week and the attendant shortage of hotel rooms. Fortunately, the Victorian government has not been able to put on a sporting extravaganza on this occasion to foil our plans.

As I said on the previous occasion, it is worthwhile recognising that accountability includes being accountable for what I said last time, so I will start by reviewing how that has stood up over the last six months. Last November I summarised our expectations by saying that I thought 1997 would prove to be a good year for economic growth with GDP growing by about four per cent, and that inflation would remain below two per cent for a while but with a tendency to pick up as we went through 1998, and that there was a good chance that unemployment would decline.

I said very little about the current account and the balance of payments as the outlook for Asia was still very unclear. We had only two quarters' data on economic growth for 1997 at that time. Now we have all four and the ABS records that GDP grew by 3.6 per cent over 1997 and non-farm GDP by 3.8 per cent. Both are slightly less than the four per cent I was expecting, but I do not think there is much point in making a lot over that small difference.

The main reason I do not think there was much point in making a lot of that small difference is that the outcome for the labour market turned out to be a bit better than we expected at that time. The average unemployment rate in the first half of 1997 was 8¾per cent. When we met in November, the most recent figure we had was 8.6 per cent. The run of numbers we have received over the past few months have been either 8.2 or 8.1 per cent. If you looked across the past 12 months you could see a reduction in the unemployment rate of about half a per cent or so. Over the course of 1997 the combination of good growth

and moderate outcomes on wages made some inroads into our unemployment rate.

On inflation, I have little to add to what I said last time. Underlying inflation has been 1½ per cent over the last 12 months. We are still expecting that it will rise over the next 12 months largely because falling import prices, which were pushing inflation down, have given way to increasing import prices. In fact the fall in the exchange rate meant that wholesale import prices have risen by 7.7 per cent over the past 12 months. Import prices made their first positive contribution at the retail level to the CPI in the March quarter, after seven quarters when they were pushing it down. These changes are not alarming but they do tend to suggest that we are past the low point in the inflation cycle.

I feel reasonably comfortable with our earlier assessment except in one respect, which the chairman mentioned. Last time we met the full extent of the Asian slow-down was still very uncertain. In fact it is quite interesting that as recently as six months ago most discussions treated the ASEAN 4 as being the known extent of the Asian slow-down. We did not know at that stage, although the possibility was flagged, that Korea would join them, that Indonesia would deteriorate significantly further and that Japan would suffer a relapse into recession. When we take these developments into account, it is clear that a bigger external and contractionary effect has now to be factored in. I will return to that subject in more detail later.

So much for 1997, what about 1998? In the absence of the external shock from Asia, 1998 was shaping up to be, if anything, a stronger year than 1997. There was nothing in the internal dynamic of the economy which was pointing to a slowdown and we had every reason to expect growth of four per cent plus. That will no longer be the case and we are now looking at growth through 1998 of something more of the order of three per cent. This would probably mean that after a year in which the unemployment rate came down, we might be looking at a year in which it basically flattens out.

I mentioned the outlook for inflation when I reviewed the previous year's results. Broadly speaking, we think that the trough in the inflation rate has passed. It is moving back into the two to three per cent range, but it is not doing so in an alarming way. We expect it to be in that range by the end of this year and probably rise a bit during the next year.

Another part of the economy, which in Australia has always been closely watched, is the current account of the balance of payments. With domestic demand in Australia growing at or above trend, but with a number of our major export markets declining, it is an arithmetical certainty that the current account has to widen—as it has. This is not a sign of economic policy failure and I trust markets will treat it accordingly.

A number of people, including myself, have made the point that on this occasion the widening of the current account deficit is not the result of excessive growth in domestic demand, nor is it the result of decline in competitiveness because of high Australian inflation, nor is it the counterpart to a large budget deficit. For these reasons we expect it will not arouse the same excitement that it has in the past; though we can never be sure about that. At present, our expectation is that the current account deficit in 1998 will be about 5½ per cent of GDP. But, if you look at the cyclical behaviour of the current account over the last two decades, you could not rule out it touching six per cent for a time.

Imports are probably slowing from their very high growth rate in the second half of last year, although

the figure for March did not really confirm that. Over the course of 1998 we still expect them to show their usual behaviour; that is to grow by a few percentage points per annum faster than domestic demand. Exports, on the other hand, cannot hope to keep up with last year's pace of 8½ per cent and a small positive figure is the most we can hope for.

Most of our exports—our rural products and our metals and minerals—are sold into worldwide rather than country specific markets. If we cannot sell zinc or copper to Korea we sell it to another country. The same goes for our rural exports. It means that, for two-thirds of our exports, what we earn is a function of world demand, not the demand of our specific and largely Asian trading partners. At the end of the day the prices for these commodities adjust to clear the market and that has been happening; prices have been going down. The prices of Australian commodity exports have fallen by nine per cent over the past year when measured in terms of a neutral basket of currencies. But, at the same time, the Australian dollar has fallen against this neutral basket of currencies. So our commodity prices in Australian dollars—what our exporters actually receive—have gone up slightly.

Even for our biggest exports—coal and iron ore—where prices are renegotiated annually, the Australian dollar prices in contracts which commenced in April this year were higher than in the contracts a year earlier. This is an example of the market adjusting—in this case the foreign exchange market—to shield the export sector, but not the whole economy, from the worst of the Asian downturn.

Having made these points, I do not want to give you the impression that I am downplaying the effects of Asia. To the contrary, the biggest difference between the way we view our immediate future today and the way we viewed it a year ago is clearly the external shock we have received from Asia. While it is true that the Australian business cycle is always affected by the world business cycle, the current Asian crisis is the first significant identifiable external shock we have had for a long time. The last time I can remember something as specific as this was OPEC 2 in 1979. But that was, of course, on a much bigger scale and it affected the whole OECD area more evenly.

The current Asian crisis is unusual in that Australia has a bigger exposure to it than any other OECD country other than the two which are actually part of the crisis, Korea and Japan. We have always been very conscious of Australia's vulnerability to a sharp contraction in Asia, but it has always been our hope, and certainly the guiding principle behind Australia's policy, that the economic problem in Asia could be minimised by prompt action. It was this awareness of possible danger ahead that lay behind Australia's very quick response to the Thai crisis and the Reserve Bank's willingness to put funds from its balance sheet at the government's disposal to ensure that Australian participation was not delayed. It also explains why Australia is the only country other than Japan to be a part of all three Asian support packages—those for Thailand, Indonesia and Korea.

Australia has done what it can to minimise the Asian fallout but clearly events have turned out worse than we had hoped for. The crisis has spread further than was first thought likely. It is resulting in larger falls in output and employment in the countries concerned, and finally, it has been compounded by the relapse of the biggest Asian economy, Japan, into recession. What started as a currency crisis in Thailand is leading to widespread suffering in a range of Asian countries.

Of course, those countries have some deep seated economic policy deficiencies: weak banking sectors, too much of what is now called crony capitalism, too much government direction of investment including implicit underwriting of loans and insufficient disclosure, poor accounting standards, et cetera. These deficiencies are common to most countries at earlier stages of development than ours and they have been around for decades. They did not deter massive capital inflow for most of this decade and I suppose it must be galling for some of these countries to listen to sermons on their deficiencies delivered by international bankers who until recently were happy to ply them with loans.

We all have to agree that these countries made policy errors. That is par for the course. Yet I agree with Paul Krugman who, when commenting on the current situation, said, 'Governments are no more stupid or irresponsible now than they used to be. How come the punishment has become so much more severe?' These countries have had to make a very rapid adjustment to their external positions to stop their exchange rates from falling below the extremely low levels they reached in late 1997. They could not rely on a resumption of capital inflow to stop the problem, so the only feasible way was to return their current accounts to surplus. This has involved very tight policies, a very large fall in domestic demand, and very large falls in imports. For the three countries in IMF programs, we estimate that their imports have fallen by between 30 and 40 per cent over the last six months. Even though there has not been time for them to expand their exports, their current accounts have already moved into substantial surplus.

Australia's exports to these countries appear to have fallen, roughly in line with their falling imports. In other words, we have had a very substantial fall in our exports to these countries. Thus we have received the effects on our trade flows quite early in the piece. You can date it from about December. If you look at a graph of the Australian current account, there is a very sharp turnaround in the month of December towards deficit, and that has continued in the first three months of this year. In time, when these countries' exports pick up, we should start to get some benefit from it. But, at the moment, all we are receiving is the disadvantage of our exports falling in line with their imports.

To date we have coped quite well with this situation largely because we were in good shape going into it, with strong domestic demand and low inflation. This was due in part to the fact that we had taken expansionary monetary policy action between July 1996 and July 1997. The other way in which we have coped well is that our financial markets have behaved very sensibly. It is true that our exchange rate has depreciated against the US dollar and against other major currencies, but this is an understandable market reaction to the deterioration in our international trading position. Apart from a minor panic in January, the whole process has been very orderly.

The bond market too has performed very well. International and domestic investors have clearly drawn a distinction between Australia and our Asian neighbours and we have not seen any risk premia on Australian bonds. Indeed, we have improved our position over the period and Australian borrowers can now borrow in Australian dollars at or below the same rate as equally creditworthy US borrowers can borrow in US dollars. The Australian share market has also risen over the past six months and, even though it has not performed as well as most overseas markets, it is higher than its former peak in mid-1997.

What is the implication of Asia for the conduct of monetary policy? The simple answer is that it makes it more difficult. The Australian economy has suffered an external shock: a significant reduction in

demand for our exports which will lead to lower export volumes in some cases and lower export prices in others. This will show up in some combination of lower economic growth and a widening of the current account of the balance of payments. Because of the fall that has occurred in the exchange rate, it will also show up as higher inflation than otherwise.

Even if we had perfect foresight, we cannot adjust policy in a way which would avoid these outcomes altogether. The best that we can hope for is a combination which minimises the longer run disruption to our economy. Choosing the monetary policy to achieve this is not an easy task. It involves constantly reviewing our position in the light of changes in our economy and our forecast of future events and, importantly, it will be heavily influenced by how the Asian situation develops.

I repeat that the only reason we are foreseeing any slowdown in growth in 1998 is because of the Asian crisis. There was nothing in the domestic economy that pointed in that direction; in fact, it pointed to higher growth. I suspect that in the future evolution of our policy, Asia will be the major influence.

As you know, the Board of the Reserve Bank met on Tuesday and did not make any change to the setting of monetary policy. There had been some speculation over the preceding month that we might ease, but the majority of outside observers expected no change. Our on-balance view is the same as that of the majority of outside observers, that is, we judged that the present setting is the right one, as we see it. The present stance of monetary policy provides a low interest rate environment which is working to support rather than to restrain growth. Credit is readily available. Borrowers regard current interest rates as attractive. Their financial wealth is rising, as is the leverage of the private sector.

Developments in the exchange rate and interest rates charged by financial intermediaries since the last reduction in the cash rate in July last year have worked to magnify the effects of lower official rates. The exchange rate has come down against major currencies and competition among banks has reduced interest rates to business and personal borrowers.

The most likely outcome over the next 12 months at the present policy setting is for inflation to return to its target range and for domestic demand to remain at or above trend growth. With a significant reduction in net exports, however, GDP will probably grow below its trend rate, but some growth slowdown in the short run is an unavoidable result of an external shock of this magnitude.

Our measured approach to date has served us well in that it has maintained confidence in Australian financial markets. That, of course, does not rule out further changes in policy but it does impose a constraint in that it means monetary policy has to be adjusted credibly. We do not wish to jeopardise Australia's current good international standing or revive memories of when Australia was regarded as a boom and bust economy. We gain a lot from our current reputation for stability. Not only does it reduce our borrowing costs, but we can raise equity more cheaply and we have become a more attractive place for direct foreign investment.

We recognise that it would be a mistake to stick too long to a setting of policy in the name of stability if there were good reasons to move. We have to be conscious of the risks to our current assessment and constantly review them. The major downside risk which we can see is the possibility that the effect of the Asian and Japanese situations might produce a larger slowing in the Australian economy than our current

expectations, perhaps indirectly by slowing growth substantially in other trading partners or by seriously dampening domestic demand through income or confidence effects. Such an outcome is not, in our view, the most likely one but it has some probability.

I do not want to go on for much longer. I have said nearly enough for the time being, even though I have not covered a few topics that I know the committee is interested in, for example, the effect on aggregate earnings growth of the two safety net review increases, the contribution of increases in executive salaries to aggregate earnings growth, and competition among banks to lend to small business. I am happy to answer questions on these subjects in the course of today's discussions but it might be better for me to finish this monologue and get on with the questions and answers. Thank you very much.

CHAIR—Thank you very much, Mr Macfarlane. We certainly appreciate the detail you put in that opening statement. The committee would like to start by asking you questions on monetary policy and we will come back to those last points that you raised after that.

I would like to begin by questioning you on the issue that I raised in the first question at the last hearing, notwithstanding your comments about the meeting that the board has had this week. I think you responded to my question then on interest rates that you had nearly all the factors in your pocket for a change. Given the comments about the Asian crisis, you have now had six months to assess the impact from the last hearings, at which time you rightly pointed out that it was fairly early days. You did see the possibility of the Asian situation becoming more difficult, and I think your words were that while you did not expect it, this does have some probability. My question, therefore, is: how far down the track would it be before you might have to review that interest rate position?

Mr Macfarlane—Mr Chairman, your reference to the previous discussion I think was a reference to our May meeting.

CHAIR—Yes. It has been 12 months and no change.

Mr Macfarlane—No, it has not been 12 months and no change.

CHAIR—Well, almost.

Mr Macfarlane—You are right; the May meeting was a particularly difficult one because we felt that the majority of things had fallen into place, but one or two had not, and then they did shortly afterwards. In November, that was not the case because, by the time we got back and had our meeting in November, we had already done two extra easings: we did one in late May and we did another one on 31 July.

Certainly, in the second half of last year, the possibility of an easing was not even on the agenda. The economy was growing extremely quickly. In fact, the figures suggest that, in the second half of last year, domestic demand was growing at seven per cent per annum, non-farm GDP was growing at 3¾ per cent per annum and the unemployment rate was falling by half a per cent, although it was not apparent that the unemployment rate had fallen that much at that time. Certainly, when we met in November, I do not think it was a serious consideration. It is a consideration now. It is something that people are speculating about and it

is something that we have thought very seriously about.

Your specific question was: how long will it take for us to know whether the Asian crisis is much more severe than we currently think it is? I am not sure that I really have an answer to that other than to say we will monitor it extremely closely as we go along. At this stage, we have to make our monetary policy judgments on what our current assessment is. Our current assessment is, as I said, that our economy will grow somewhere in the order of three per cent during the course of 1998, which I think will be a good result, considering the size of the negative external shock we have received. We have to make our assessment on the basis of our inflation forecast, which tells us that we have passed the trough in inflation and we are moving back to the middle of the range at some stage early next year.

At this point, we really have to make our judgments on those sorts of forecasts—how we see the next six to nine months, or a year, unfolding. On the basis of those judgments—and we sat down and talked about it two days ago—we concluded that we thought the stance of policy at the moment was the right one.

CHAIR—Maybe I could just expand on those comments. I refer to the situation in Asia, with 60 per cent of our exports. You probably saw an article today in one of the newspapers about possible problems with China, which is one of the countries where we have significant exports which, to date, has not felt the same effects. What are the real danger signs that you would see that would lead to a reconsidering of that position?

Mr Macfarlane—One of the differences between now and when we were thinking about this, even a couple of months ago, was that we had a model in our head where we felt that the immediate impact of Asia would be felt on financial prices. The immediate impact would be felt on the exchange rate, interest rates, share markets and things like that, and the actual economic effects would come through very slowly. For example, the effect on our exports would come through very slowly and we would start to see these things get bigger and bigger as we went through 1998.

At the moment we are actually reassessing that second assumption. We are thinking that they are actually coming through faster than we thought. We think that we got the first very clear hit in terms of weak exports in December. We have really essentially had it in December, January, February and March. The current account has deteriorated very quickly—more quickly and sharply than in our forecasts.

Mind you, half of that deterioration is not due to weak exports; half of that is due to extremely strong imports. Imports are growing. In the March quarter, in volume terms, they grew at about a 10 per cent annual rate, as best as we can judge. So we have still got the impact of the strong domestic demand leading to strong imports, which is in some sense encouraging, because a lot of that domestic demand is not going to go into imports; a lot of that domestic demand is going to go into the domestic economy. At the same time it appears to us that the fall in Asian imports, and therefore the fall in our exports, is coming through very sharply.

When we looked at the figures for Asian countries recently, Thailand had reduced its imports by 40 per cent in the last six months and Indonesia and Korea by 30 per cent. Those are massive falls. That is why the effect has come through to us so much more quickly.

There is a good side to this as well as a bad side. The good side is that you cannot keep reducing imports by 30 per cent. You cannot do it again in the next six months. You basically have a massive downward shift. I am not saying you cannot reduce imports by a further amount; you can. But I cannot believe, having fallen by 30 or 40 per cent, that you can repeat that in the next six months. What we are really expecting to see is this huge fall in imports, followed by something that would look more like a flattening out, because they have already got their current accounts into substantial surplus.

In a sense, we were disturbed at first to see how fast our current account was deteriorating, but on the other hand, I think there is an encouraging aspect to that as well, in that what it tells you is that the second half of the year is probably going to look better than it would look if they were delaying their adjustment and doing it through the second half of this year.

We cannot forecast these things with complete accuracy. We think that the countries that have had to do the most extreme adjustment have done it quicker than we thought. We think that the flow-through to our exports has come through quicker than we thought. That is good, because it is getting some of the adjustment out of the way. The adjustment only has to be of a certain size. More of it has been completed than we thought. But we still cannot foresee what is going to happen to other economies in the region. We cannot see the extent to which they are going to slow down—Taiwan or Japan. Really, if anything, Japan is far and away the biggest uncertainty in the region.

CHAIR—I wonder whether you could expand on that. Clearly, as our biggest customer, given that their economy is at best flat, where do you see that?

Mr Macfarlane—Saying it is at best flat is flattering. It is clearly declining. We were lucky last year in that our exports to Japan actually went up at a reasonable rate because Japanese exports were quite strong. The Australian economy's relations with Japan are really tied into their exports rather than to their domestic demand, so we certainly think that the domestic economy is going to decline in 1998. We are not so sure about exports. We think they may still continue to grow, and therefore we may get some positive growth, but nowhere near as strong a positive growth as we got last year.

Dr SOUTHCOTT—Do you think that will continue in Japan, because Australian exports are important, as you said, to their exports? Do you expect that slight increase that we saw over the last year with Australian exports to Japan to continue?

Mr Macfarlane—I think last year we had more than a slight increase, we had quite a good increase to Japan. In our forecasts, as best we can see at this point, we have factored in very small positive export growth to Japan, but last year it was up about seven per cent in volume terms, I think.

Mr WILTON—In July 1986, when you were Chief General Manager, Financial Markets, the bank tightened monetary policy to support the dollar. Would there be a need, in your view, for a repeat performance if trade deterioration, for example, forced our dollar to, say, below 60c?

Mr Macfarlane—I cannot really speculate about the future movements in the Australian dollar and, therefore, I cannot really speculate about what our action would be. However, I am glad you raised the

question because I would like to go back and talk about that period because it has got some relevance, not just for us but also for what has happened in Asia.

What happened in 1985-86 was that we had a loss of confidence in the Australian dollar and a massive capital outflow. It was caused because there was a sharp widening in the current account and, at that stage, what accompanied it was a very sharp increase in external debt because we started off with almost none and it went up at a very sharp level. This alarmed a lot of people. In the middle of it all, we then had a collapse in the terms of trade and people got even more worried. What we had in 1985-86 was somewhat similar to what Thailand had in the middle of 1997. We have not got anything like that now—and I will explain that later.

We had an outflow of capital. We also had a strong suspicion then about Australian monetary policy and about Australian fiscal policy. There was very little confidence in our policies, the current account was widening, debt was going up, commodity prices were falling and we had a classic example of capital outflow. In fact, our exchange rate fell by 39 per cent in the space of 18 months, which is not that much smaller than some of the things that have happened in Asia.

What did we do about it then? We made the classic response, which was to tighten monetary policy—interest rates went very high in 1985-86—and tighten fiscal policy. The exchange rate itself went down, and as it went down it started to look a slightly better buy the further it went. Eventually, in the space of 18 months, the problem was solved. The international markets regained confidence in the Australian dollar, they regained confidence in Australian economic policy, and capital started to return—we started to receive capital inflow in bigger amounts again and the Australian dollar went back up.

The interesting thing there is that we started with a current account deficit of about six per cent of GDP and, with the tightening of fiscal and monetary policy, the economy slowed down. It did not actually decline. I think domestic demand slowed to zero and GDP growth was half a per cent or something in 1986. As a result of that slowing in the economy, the current account deficit was reduced approximately from six per cent of GDP to three per cent and everything, in a sense, was resolved after that. Confidence returned and we went on and grew successfully in successive years.

The reason I want to mention that is that in Thailand's case, for example, they started off with a current account deficit of eight per cent of GDP. They have had to slow their economy to such an extent that they have turned that eight per cent of GDP deficit into a four per cent of GDP surplus in about one year. In other words, the cost to them of adjustment has been 12 per cent of GDP—the cost to us was three per cent. In other words, for a variety of reasons, because people had more confidence in our institutions, we never actually reached the point where there was net capital outflow. The capital inflow was reduced from six per cent down to three per cent, and then it came back up again.

In Thailand, the capital inflow was eight per cent and it has gone into negative territory. The only way they can restore the situation is to have this current account surplus. That gives you some idea of the order of magnitude of the adjustments they are going through. It is four times as big as the adjustment we went through in 1985-86. As I said, our adjustment did involve domestic demand becoming zero for one year.

Turning to our current situation, I think the international markets have a huge amount of confidence in the soundness of the Australian economy and the soundness of Australian economic policy. It is just as well because, in the end, that really determines whether you have to make one of those big, costly adjustments. So it is absolutely imperative that you keep that confidence, and we certainly have that at the moment. That is why we look closely at all these sorts of indicators. We look at whether there is any sign of a risk premium on our bonds, what is happening to our share market, what are people saying about us and how easy is it for our companies to raise equity if they want to raise equity abroad.

That is the secret. If you maintain the confidence of not just the international markets but your own markets as well—your own banks and investment companies—then you can get through a situation where the current account goes up and down or widens, as it is going to do at this stage, without having to make a savage adjustment. You only have to make that savage adjustment if you have lost the confidence of your international and domestic institutions. That is why we have always placed a high priority on retaining that confidence.

Mr WILTON—This is an easier question for you. Is it conceivable that, in the future, the bank may countenance more minor adjustments to policy, say, in the order of 25 base points, as in the UK and the US?

Mr Macfarlane—Yes, it is conceivable. The fact is that, in the early 1990s, most of our adjustments were by one percentage point because we were working off a very high interest rate base. You needed to move by quite a big amount to have any impact in those days. As interest rates have become lower we have tended to move by amounts which are more often half a per cent, but there is nothing sacred in the actual amount that you move.

Mr CAUSLEY—I want to go back to the Japanese situation. It is clear that the Americans have some concerns about the Japanese economy. The President said, I think, that he wanted to meet the Prime Minister sooner rather than later. Do you see that there are genuine movements in Japan to address their economic problems?

Mr Macfarlane—I will have a little go at this and then I will hand it over to Steve because he might know more about it. It is very frustrating when looking at Japan's policy making processes—extremely frustrating. What they seem to have managed to achieve over the 1990s is a significant deterioration in their fiscal position without ever having, along the way, achieved a Keynesian expansion. They have had numerous disappointingly small fiscal expansions, none of which have been enough to change people's expectations or confidence about the future, but each time their budget deficit gets a bit bigger. It has been very, very disappointing.

I think they will gradually get there, and I think this package is probably a bit better than the previous ones, but you would not want to hold your breath and expect decisive action, particularly since they seem to be going through a period where they are looking for scapegoats rather than looking for ways of coming out with new policies which offer a lot more promise than the ones they have come up with over the last five years. Steve, I am sure you can do better than that.

Dr Grenville—I can perhaps put a bit more detail in. The Japanese economy has been essentially flat

for six years now. That is an extraordinarily long length of time. It seems to be more than a cycle. I think this is perhaps one of the points to make, that, in trying to figure out where Japan is going, we need to figure out what is the normal cycle—and you would hope you would come out of that—and what structural issues are there which, if they are not addressed, could keep the Japanese economy weak for longer.

In terms of the cycle and so on, I think in a way some of this is simply bad luck, the way things came out. They had the huge asset bubble in the late 1980s, so that, in a sense, was a bad way of going into a period in the economy because you had to get rid of a whole lot of the bad effects of that bubble in the late 1980s. When they got to the 1990s they had their exchange rate go to 80 to the dollar—an extremely strong exchange rate, which of course makes exporting much harder, and that was a thing that slowed the economy.

In all of this time they have been conscious that their starting fiscal position was not all that good, and they have always been reluctant to really have a large fiscal expansion. So, even though they have done in fact, on my count, eight major fiscal packages since late 1992, a lot of these have been things that had a certain amount of puffery about them, a certain amount of exaggeration in the size. And, maybe, more importantly, a lot of them were bringing forward expenditure from future years. And that was fine, that got you through this year—you brought next year's expenditure forward to this year and that helped you this year—but then, when you got to the next year, you found a hole in the economy and you had to do more. So we have had this impression of a series of big fiscal packages which in fact have not been quite as big as they seemed, and of course in lots of ways they were simply bringing forward expenditure.

If that is the way you view it, you would perhaps say that there is room for them to get back onto a normal pace of growth. Indeed the IMF forecasts, which you can see in table 2 of our statement, while they have zero for the current year—extraordinary figures, zero GDP growth—they have small positives for the following year. So I think that would be, in a sense, the most common view, that this is the low point and they will do a little bit better.

But whether they do a little bit better or a lot better depends very much on the second issue—that is, the issue of whether they can address the structural issues. There are a series of them here: ageing population; an economy which has traditionally had a lot of government interference, if that is the right word—a lot of relationships between government and business—and I suppose those things are being broken down over time; and perhaps, most importantly, a financial sector which has not been helpful to the process of business and intermediation over recent years.

The financial sector clearly was in deep trouble in the first half of the 1990s, and the perception of most people was that, over time—given that they could make reasonable profits—the financial sector would sort itself out, the banks would get rid of the big bad debts which they had. And I think that has happened, but the process has taken a lot longer than anyone ever expected. And now we have got the prospect that the so-called 'Big Bang' in Japan has started—fiscal deregulation—and in the short run that will put pressure on the financial sector, but, in the long run, it is part of that process of deregulation and structural change that they have to go through.

What is the long and the short of that? I think, adding the two things together, the structural changes clearly have some distance to go, but they have embarked on those and the cycle, with the extra fiscal

stimulus that was put in late last year and recently, is likely to at least get out of this zero growth that we are seeing at the moment. Whether Japan can get back to faster rates of growth really depends on the extent of this structural change. The interesting contrast at the moment is that we are seeing a dichotomy between the success in the US and the apparent failure in Japan. Many people are seeing that as some kind of resolution of a big debate on how you should run the economy between America, the land of the free market economy, and Japan, the land of MITI and close relationships between governments and the private sector.

I think we are seeing Japan at a moment when a lot of people who have a big interest in that debate are essentially saying how well America is doing. There is a feeling of triumphalism about America and, by implication, and maybe to show how much better America is doing and how much better American systems are, the failures of Japan. This is maybe a bad moment to make those kinds of judgments because I think there are moments in the cycle. We see America at a very positive moment of its cycle and we see Japan at a low point of its cycle. I think, when the dust settles, we will find that that debate still goes on. This is not going to settle it, and Japan will shift quite some distance in the way of freeing up its economy and that, over time, will get it in better shape to get back to reasonable rates of growth.

Mr WILLIS—It has been said by some people that Japan is in a quandary because, leaving aside the point that you make about the 'bring forwards' and the lack of so-called 'real water' in these fiscal packages, nevertheless, they have managed to blow out government debt to about 100 per cent of GDP and deficits are running at around four per cent of GDP. In those circumstances, they are being told by the international financial community, certainly by other countries, that they should spend up bigger and get into more debt, which is not the normal prescription one gets for other countries.

What has been said by some commentators is that Japan is in a real bind because, whenever they undertake these packages, the population becomes more worried about the future as they see government debt increasing and increase their savings, so private sector saving goes up and consumption goes down at the same time as public savings go down and consumption goes up, and so there is no net result. Do you have any comment on that?

Dr Grenville—It is certainly a serious issue. Looking back over these series of packages during the 1990s, you can see a definite pattern. When they were spending on the fiscal side, the economy did start to move forward a bit. I suppose the best example of that is if we compare 1995 and 1996. In 1995, they had the exchange rate moving against them and they had some of the holes which appeared out of earlier fiscal packages, and so the economy slowed in 1995. They did a rather large package towards the end of 1995 and coming into 1996, which actually did get the economy going in 1996. I think it would be too much to say that these fiscal packages do not work.

I think they do work but the critical issue is whether they generate self-sustaining growth of the economy. With the actual money that is spent in the fiscal package, some of it is saved, but these packages have been big enough so that there was still a fair bit of 'real water' left in them and it did indeed work. But none of them so far has generated this self-sustaining growth.

They were very reluctant to use the latest package for the reasons that you say: they have already clocked up a lot of debt; the budget deficit is perhaps even larger than the four per cent, depending on how

you measure it; and the Prime Minister had undertaken to have a process of fiscal consolidation which had been written into law. They had targets by the year 2004—they had to get the budget deficit down to three per cent and these things had to be fixed. These things constrained them, but I think they have recognised that the situation is so serious that you have to put those issues aside for a moment and get along with the new package.

The new package has a couple of extra elements in it which it seems to me will be helpful. They have been prepared to put some money into the financial system—direct money into banks. I think that is an element that has been missing in past packages. It seems to me that this package will have some effects; some will be saved, it will have some effect. The critical issue, as I said earlier, is whether it is going to be combined with some structural changes—the deregulation—which might mean that the package leads to self-sustaining growth.

Mr WILLIS—Okay. Coming back to Australia, one of the more surprising elements of the Asian crisis, I suppose, has been that although we devalued significantly against the US dollar, we have devalued very little against the TWI. As you have indicated in your document, there are enormous variations in the way our exchange rate has behaved against different currencies. We have devalued considerably against some and, against the Asians, we have appreciated considerably. But nevertheless, with the prospect of a current account buying out the six per cent of GDP—well over $30 billion—is it surprising to you that the TWI is where it is, with very little devaluation? Is there a case for saying that part of the adjustment process that needs to be undertaken in the circumstances is a devaluation of the Australian dollar; and does monetary policy have a role to play in that?

Mr Macfarlane—I am happy to answer that one because I think part of the solution to that conundrum you are looking at is that, in these extreme circumstances where we have appreciated massively against a few currencies and gone down against all the rest, the TWI is, regrettably, a rather misleading indicator of changes in our true competitive position. We have been conscious of this for some time. We wrote an article on the subject which we published in our January Bulletin. How can I explain this? If I buy a set of golf clubs from America they are going to cost me 10 or 12 per cent more now because we have gone down against the US dollar, I know that, I have seen it coming through. The TWI assumes that if I also then go out and buy a Korean car, its price will have gone down by 40 per cent in Australian dollars. Of course, it hasn't, we know that. Basically, they did not need to keep their prices constant in won; they put their prices up in won, and set them at the rate which is going to do the right thing for marketing their exports around the world. So, for those reasons, the TWI is actually giving the wrong impression. It is implying that those countries whose currencies have fallen by these huge amounts—like 30 or 40 per cent—actually reduced their prices to Australia by 30 or 40 per cent. They have not.

So we started looking at better measures of the competitiveness of Australian exporters and importers. One of them is to look at the TWI and weight it by imports, rather than by exports, because that is the one that is relevant for inflation and it is also the one that is relevant for all our import competing firms. If you do that, we have actually been coming down significantly since, say, July last year. We have depreciated by 6 per cent on that one.

Another way of calculating the exchange rate is to look at who our export competitors are in

international markets. If you do it that way, we think that our competitiveness has increased by about five per cent—that measure of the average exchange rate has come down by about five per cent. If you just looked at the Australian dollar against major currencies—G7 currencies—we have come down by about 12½ per cent compared to the two per cent which the TWI would show.

Our feeling is that if you look closely at how these things are constructed and at the actual pricing behaviour of the countries concerned, the TWI is not giving the right impression. It is true that the fall in the exchange rate against the US dollar is overstating what has happened to the Australia dollar. A lot of people look at that one; they do not look at anything else. But I think the TWI is understating it. The real truth, in terms of the measures of the exchange rate which most summarise the position of our exporters or our import competers, would have the exchange rate having gone down by a further five or six per cent since the middle of last year. We think there is actually something that is working there to make those things more competitive.

Mr WILLIS—I take it you accept the point that in the context of a current account change there does need to be a devaluation, but what you are arguing is that, although the TWI does not tell us we have had one, we really have?

Mr Macfarlane—Yes. Indeed.

CHAIR—Do you have the employment figures there? Can you read them out.

Mr Macfarlane—The April employment figures are up by 58,200, and the unemployment rate is 7.9 per cent. Full-time jobs are up by 42,000, and part-time jobs are up by 16,000.

CHAIR—Thank you.

Mr Macfarlane—I have to say that that is a relief.

Mr WILLIS—I notice that you say in your comments in the document that there was a concern about the lack of employment growth in the last three months. I presume that, in the light of those figures, you are rather less concerned about that lack of growth. Nevertheless it is the case, as I understand it, that employment growth over the period of the last 18 months or so—leaving aside today's figures, but certainly up until today—had not been enough to meet the growth in the work force generally to reduce the rate of unemployment and that the reason the unemployment rate went down, essentially, was that we had a fall in the work force participation rate. Without that fall, we would not have had much of a fall in the unemployment rate at all. So we have not been getting very good employment results. Obviously they dance around from month to month but, on the basis of the last 18 months or so, my understanding is that employment growth has been disappointingly low and that we have had to rely on the participation rate decline to reduce unemployment.

Mr Macfarlane—I think the decline in the participation rate occurred a bit earlier. I think it was really from about mid-1996 to the first half of 1997 that the participation rate came down. But over the last 12 months the participation rate has been broadly stable.

Mr WILLIS—I was going back 18 months.

Mr Macfarlane—So that certainly was true for a time. And if you stretch the time period back far enough, you can incorporate it. But over the last year, I think the participation rate has played a very small role.

It is true that there were a lot of worries about the way the labour market was developing, and we were looking very closely at that. It was almost too good to be true in the second half of last year because between August and November 1997, employment grew by 1½ per cent—that is at the actual rate. That is as much as you would get in a full year, normally, or in a lot of years you would get 1½ per cent. We had this big jump in three months and, since then, it has really grown much more slowly. I think the March quarter average over the December quarter average was about 0.3 per cent and, if you went through the March quarter—January, February and March—it was looking very weak, so there was a worry.

It was a disappointment because, on the basis of an economy which had grown as fast as ours had—GDP had grown at 3¾ per cent through 1997—and since employment usually lags GDP growth, we were expecting better employment growth in the March quarter than we actually got. As I said, this figure is a relief because it is a very big one, and when we average it in, we start to get something that looks a bit more plausible, in line with the economic growth we had in 1997.

Of course the other thing we had which made us think that we were due for some employment growth was that vacancies had actually been rising and were at a level which is normally consistent with some decent employment growth. I think the moral of the whole thing is that month to month, and even quarter to quarter, there is so much variability in these numbers that it is very difficult to construct a story.

It seems to me we probably were flattered by what happened in August and November. What happened from November to March was probably understating what was going on. The March figure is obviously overstating what has happened in the particular month but, when you average it in with the others, I think we are starting to see a rate of growth of employment which is more consistent with what we know about the rate of growth of output.

Mr WILLIS—Presumably with your forecast of three per cent growth—is it 1998 or 1998-99?

Mr Macfarlane—It is through 1998.

Mr WILLIS—You would not expect to have a strong employment growth in that period. If it goes down three-quarters of a per cent, one would expect that that will show up in employment quite considerably.

Mr Macfarlane—I said that I thought that the unemployment rate would probably flatten out. That would probably be as good as we could hope for in the course of 1998.

Proceedings suspended from 11.37 a.m. to 11.47 a.m.

CHAIR—While my colleagues are coming back to their seats I might just bowl up one quick question

to you, Mr Macfarlane. One of the areas about which there has been some speculation recently is what might be happening to interest rates in the United States. If the Federal Reserve were to increase interest rates, what response would you expect in Australia?

Mr Macfarlane—If the Federal Reserve did increase interest rates and they increased them successfully—if, in other words, the US economy had the desired result which was that no panic ensued; if it were simply a small shot across the bow for the US economy, maybe a small fall in Wall Street or something—I think we would take that in our stride. We would regard that as the US just doing their job. It, of course, would widen the interest differential somewhat between the US and Australia so it may have some minor impact on the exchange rate, but it would not necessarily have any implications for the Reserve Bank in its conduct of monetary policy. It is something we would take on board. We would look to see what it did to financial prices, but my feeling is that if it were accomplished as successfully as I described, it would be something that we would be able to take in our stride.

There are other people who have much more alarming scenarios of an increase in US interest rates causing Wall Street to collapse and all the rest. If that sort of thing were to happen, I would have to revise my answer but I am not expecting that.

Mrs GALLUS—Back to monetary policy: today, you have given us a picture of 'steady as she goes'; that there are very rough waters out there and we are putting forward a very steady course of staying on the same settings as we were. But I put it to you, isn't there a possibility that there could be a different way of looking at the factors in an alternative scenario? First of all, growth is lower than would have been anticipated a year ago because of the Asian crisis and it is certainly lower than we had expected. Inflation, in your words, is under containment. Even in your 1999 scenario, you are forecasting only 2½ per cent inflation which is well below the three per cent target. The wage increases which you were concerned about at our previous meeting seem to be no longer a concern. The increases have eased and they have steadied at under four per cent. We had really good news today on unemployment, but it is still high at 7.9 per cent—much lower than it was, but still high for unemployment. There is no boom on the horizon that we can see in Australia, certainly not with the Asian crisis—if anything, there is an anti-boom—and there could there be a possibility of easing the monetary policy to give some stimulation to exports through possibly a lower dollar.

Mr Macfarlane—All those things you say are true. I would probably submit that, going through a difficult period as we are at the moment, with this very large negative external shock—as I say, I cannot think of an equivalent, unless I go back to 1979—if we get through 1998 with those sorts of outcomes, with growth at three per cent and inflation moving back up into the range, domestic costs roughly controlled, unemployment flat, the current account, of course, widening very sharply, I think in the difficult circumstances we are in, that is not a particularly bad result.

I would be worried about it if I thought that our stance of monetary policy in some sense was constraining this—that the economy was really wanting to do a lot better but we were restraining it with our stance of monetary policy. I do not think that is the case. I think that it is pretty clear, from the way that Australian business and households are acting, that their view is that we have got quite an expansionary stance of monetary policy. Credit is growing very strongly, total credit has grown at an annual rate of 11½ per cent per annum over the last six months, business credit is growing even faster. I think the householders

think that these rates are pretty low. In fact, many of them think they are too good to last and they are switching out of variable rate housing mortgages into fixed rate mortgages.

I think the business sector is reasonably comfortable. Obviously, they can borrow relatively cheaply. They can raise equity. There is a table in there on real interest rates. Our view on real interest rates is that they are lower now than the average over the last five years or so. If you look at the actual rates that borrowers are facing, they are not only lower than their average over the last five years, they are at virtually all-time lows.

With regard to the monetary conditions, as I explained to Ralph, I think that over the last nine months or so, the currency has come down in a way which has made our exporters and import competing companies more competitive than they would otherwise be. I think that we have got a reasonable balance at the moment. You can always make a case, and we should always be looking at the case, for a change. As I said, I think if the situation were to get worse, that is something that we would have to very seriously consider. But I think at the moment our feeling is that the balance is about right.

Dr SOUTHCOTT—I wanted to ask you whether there had been any changes over the last 12 months in the expected rate of inflation based on the Reserve Bank's preferred measure.

Mr Macfarlane—On page 45 there is a table outlining inflationary expectations. The top one relates to the Melbourne Institute survey, which has been going on for about 25 years. They look as though they have come down a bit in the direction in which we want them to come down. We would regard our monetary policy as being extremely credible if inflation expectations averaged 2½ per cent. Unfortunately, we have not quite reached that at the moment. I do not know what the latest observation is but it is more like 3.4 per cent. So they have come down a bit, but they still have not got perfect confidence that inflation is going to average between two and three per cent over the rest of the decade.

Dr SOUTHCOTT—Having regard to the fact that inflation expectations have come down and yet the official rate has remained the same since July 1997, you mentioned before that most people think it is stimulatory—and we have certainly seen that most of the interest sensitive areas of the economy are growing. Do you believe that most of the impact of the easing in interest rates has now been carried through? Do you believe that the stance is perhaps more contractionary than it was in July 1997, with inflation now being so low?

Mr Macfarlane—No, I do not believe that inflation expectations are now lower than they were in July 1997. As I said, the cash rate is the same as it was on 31 July 1997. Most borrowers are facing lower interest rates than they were then. The exchange rate, when it is measured in the way in which I think makes most sense, is lower than it was then. If you were a believer in monetary conditions—indexes or things like that—and you looked at real interest rates faced by borrowers and exchange rates, I think the monetary policy is a bit more expansionary now than it was on 31 July 1997, which was when we made our last easing.

Dr SOUTHCOTT—It still does seem to take some time for the easings in interest rates to be carried through by the banks. Would you like to see more genuine competition in the banking sector so that we speed up the time it takes interest rate easings to impact on the economy?

Mr Macfarlane—We are entering into another big area. I do not know whether we want to enter into competition in banking.

CHAIR—We might come back to that. Mrs Gallus has one more question.

Mrs GALLUS—I want to follow up on that, Mr Macfarlane. The agreement with the Treasurer and what the Treasurer asked you to do was to keep to monetary policy to control inflation. I put it to you that you have done that very successfully—the government has—and inflation has come down. So that pressure on you not to ease monetary policy has gone. In the rough seas that we have been talking about there is a danger to the Australian economy in what is going on in Asia, and your policy, rather than just keeping at a steady as she goes pace, may be restricting the Australian economy, with all the other factors that are going on, and taking into account that inflation is now under control, certainly in the short to medium term.

Mr Macfarlane—If I thought that monetary policy was actually exerting a contractionary influence, your argument would have a lot more weight. We are still in a period when, as far as any of us can tell, domestic demand is growing much faster than its trend.

Mrs GALLUS—What would you see would happen if, for instance, 25 base points, as has been suggested, were taken off? What would you see being the downside of that happening? What could possibly happen that would be so negative to the economy?

Mr Macfarlane—One of the things I want to say is that there is a limited capacity for monetary policy to cause domestic demand to speed up. It is going to impact on the private sector's demand. In Australia, the private sector demand is still running quite strongly. The last figure we had showed that it was running at seven per cent per annum. Maybe it is not running at seven per cent per annum; maybe it is running at less than that now. Maybe it is running at six per cent, or maybe at five. It is still running well above trend. What is happening is that the part of the demand that we cannot influence, which is the external demand—demand for our exports—is the part that is weak. That is the part that means that this quite buoyant growth of domestic demand is not feeding through to GDP.

To a large extent, if we were successful in speeding up domestic demand to make it grow even more above trend than it is at the moment, a very large part of that would basically flow over into the current account and the balance of payments. I think it is quite possible—although we cannot be sure—that you would get a very small dividend, small or none, in terms of domestic growth, and you would get a very big dividend in terms of a widening current account deficit.

Some people will say, 'That shouldn't be a problem for monetary policy because monetary policy is not designed to try and control the size of current account.' It is true; it is not designed to control the size of the current account. That is why we have never suggested in the debate to date that, with a widening current account, we should be putting up interest rates. But I do not think it means you can be completely relaxed about how far these things widen out. If that is the main result you have from an easing of monetary policy, I think in the long run it may well put you in a worse position than you started from.

In my explanation of the question about adjustments—how you handle a situation of a widening

current account deficit—I said that, if you retain the confidence of the international and domestic marketplace, you can get through a situation like that at relatively small cost. That is what we are doing at the moment. We have not had to raise interest rates at all. I contrasted that with 1985-86 where, for a time, we did lose the confidence and we had to pay quite a price in adjustment before confidence was restored. Then I contrasted that again with the situation in Thailand where there is a sort of total loss of confidence in the credibility of domestic policies, and they ended up having to pay a massive disruptive cost to get through a situation of a widening current account deficit.

One consideration for us, if we want to minimise the longer run cost of getting through this difficult period which has been thrust upon us, is that we really have to be very careful about adopting a policy whose main effect would be to widen the current account deficit, even if it did have some other what I would imagine are small and relatively temporary domestic benefits.

Mr LATHAM—I have two questions on this relationship between monetary policy and the external account. The significant news you have given today is that the current account deficit will rise above six per cent of GDP. That is normally the point where international markets lose confidence in the Australian fundamentals. The last five times that happened, rates rose. So how can anyone believe that rates will not be rising in Australia once we get to a current account deficit beyond six per cent of GDP?

Mr Macfarlane—First of all, let me say that I said it may touch above six per cent for a quarter or so. I am not saying that that is necessarily—

Mr LATHAM—That is what your—

Mr Macfarlane—I am saying what our forecast is. Our forecast was 5½ per cent, and I said you cannot rule out a particular quarter being annualised to being above six. That is the first thing.

The second thing is that you are basically right, we slightly exaggerated, but there have been four occasions in the last 20 years where the current account deficit in Australia has risen above six per cent of GDP. On a number of those occasions it has proved costly to the economy. A classic one was the 1985-86 one which Ralph alluded to.

On each of those previous four occasions, there was present at least one or more serious policy imbalance. In nearly every case we had excessive domestic demand growth. I am saying that, at the moment, we have got domestic demand growing a bit above trend, but it is not excessive. But, in each of those previous occasions, it was excessive. I have made a study of them, and each of them has been well over seven per cent. So there was a case on each of those occasions, just on the grounds of domestic management, to try and slow the economy a bit.

Secondly, not on all of them, but at least on two of them, there was a very big budget deficit, where, for medium term reasons there were good grounds to try to pare that back; that was for a tightening of fiscal policy. In all but the most recent one—the 1994 one—those current account deficits occurred at a time when our inflation was much higher than world average. So really a combination of the first point—that is, excessive growth of domestic demand—and the fact that inflation was too high were the reasons why

monetary policy was tightened on those occasions.

On this occasion, we do not have any of those three characteristics. We have domestic demand growing a little above trend, we have inflation in line with the world average—not lower than the world average; the average for OECD countries is about 1½ per cent—and we have a fiscal position which is in pretty good shape. We do not have any of those three things arguing for a tightening of monetary policy.

Mr LATHAM—So you are arguing that this time it is different, but I would argue that the fundamentals of our chronic current account deficit problem have not altered, that we are still a small economy with poor national savings and that we find it hard to grow faster than our trading partners without a spillover on the external account. Nothing has changed in the last two years to anything relative to the 1980s experience. Those things are still true. Does it not point to the fact that the government's adherence to the twin deficits approach with its fiscal consolidation has not done anything about national savings? National savings performance is still poor. As long as it remains that way, we will not be able to grow faster than our trading partners without this triggering of six per cent GDP on the current account deficit.

Mr Macfarlane—There are two issues here: the cyclical and the long run structural. I have already covered the cyclical. The current account deficit in Australia basically fluctuates between three per cent of GDP and six per cent of GDP, and averages about 4½ per cent. If a cyclical widening of the current account is accompanied by those other imbalances, then it brings into doubt the government's policy resolve, and that is why you could get disturbances in the foreign exchange market. As I said, on the cyclical grounds we are in much better shape. We do not have any of those three issues present.

There is another issue, a longer run structural one, which you raise. You are really asking: why is it that Australia has an average current account deficit of 4½ per cent of GDP? Why has it averaged 4½ per cent? Why have the cyclical swings taken place around an average of 4½ per cent of GDP over the last 20 years? The answer, as you suggest, is because of an insufficiency of national savings. This government and the previous government have made attempts to try to increase savings. The first obvious thing to do is to stop the government from being a dis-saver. In the long run it is undoubtedly true that that is a condition for increasing national savings, although in some cases there can be an offset in private sector savings behaviour. The other thing is to encourage people to save for their retirement.

They have been the two prongs of long run national savings policy in Australia. They take a long time to work and it probably takes a long time to know whether you have done enough. I think what you are saying is that we are not anywhere near resolving that long run issue, and I would agree with you. In my view, that is not what we are talking about here. We are talking about a cyclical variation around that trend.

Mr LATHAM—On the structural, it is a sign of the policy failure of not improving national savings performance, which remains the constant constraint on everything we are talking about.

Mr Macfarlane—Yes, you are right. It is a policy failure of every Australian government we have had in the last 20 years. I give them the benefit of the doubt: I think they have both tried to do something about it. It is extremely difficult to do so. I have trouble thinking of a country which formerly had a low national savings rate and which introduced policies that caused it to move to a high national savings rate,

other than countries where a very high degree of coercion was involved—probably a much greater degree of coercion than we could impose in this country.

Mr LATHAM—On 26 March, Mr Macfarlane, you spoke in Brisbane about Australia's position relative to Asia. You mentioned it would take another paper or set of policy prescriptions to adequately describe the way we need to improve our national savings performance and said that more needed to be done. You said that was for another day. Today is another day, so perhaps you can enlighten the committee about what you think needs to be done, particularly in relation to your mention of incentives being provided for private sector saving.

CHAIR—A full paper—

Mr Macfarlane—I am sorry, I have not prepared that paper. What I was alluding to there was another speech on the subject which would require a fair amount of research. I have not done it, but I think I have given you a flavour in my answers to your questions of the directions that I would be going down.

Mr LATHAM—Bernie was always alluding to a forthcoming speech on national savings that was never delivered. I think we might just remember that for the next meeting in six months time.

CHAIR—Okay, Mark, you can write that down. I will give the next question to Mr Anthony.

Mr ANTHONY—You mentioned last week there were comments about the concern of the US market, and even the Governor of the Federal Reserve has mentioned perhaps it is starting to overheat. PE ratios are now about 28 times earnings. Certainly domestic demand is very strong—that has been our saviour due to the downturn in Asia. Do you think that the US market is starting to be overvalued? As a result, do you think the most likely mechanism that the Federal Reserve will use will be tightening?

Mr Macfarlane—I am very glad you have given me an opportunity to explain my previous comments. I have absolutely no—

CHAIR—You could have mentioned it in your opening statement if you had wanted to.

Mr Macfarlane—I have absolutely no desire to enter into the debate about the height or the degree of overvaluation of the US stock market. I was speaking to a graduation ceremony about the value of history to the students. I had no idea there were any journalists in the audience. All I said was: 'It is all very well to have technical education. It is also a good idea to have some idea of economic history. You would find it very interesting if you went back and read the discussions that the Chairman of the Federal Reserve of New York, Benjamin Strong, had with his board in the late 1920s. There are some similarities between those discussions and what is going on in the Federal Reserve board at the moment.'

It is true that I did say that the stock market was grossly overvalued by all conventional measures of valuation—I did say that. But I had no desire whatsoever to weigh into that debate, and I did not think I was weighing into it. I am conscious of the fact that Chairman Greenspan made some comments 18 months or so ago when the Dow was at about 6,000. Although it is safer to make comments about overvaluation when it is at 9,000, I did not wish to imply that I knew any more about the state of the American stock market than

anyone else in the community.

Mr ANTHONY—Do you believe there is still a close nexus between what happens in the United States and what happens in Australia? We have seen strong domestic demand. We have also seen an increase in credit for private consumers and an increase in corporate debt in this low interest rate environment. If there is a tightening in the United States, will we have the same dramatic flow-on effect that was prevalent in the eighties and early 1990s with monetary policy in Australia?

Mr Macfarlane—Certainly the relationship between the cyclical development of the economies is very close—much closer than logic would suggest that they should be. But with monetary policy I think there was a tendency to believe that we were totally at the mercy of the US.

A very interesting example for us was 1997. In 1997, for the first time in my career, first of all we put Australian interest rates down to the US level and then we took what, at the time, almost seemed a slight punt and put Australian short-term interest rates—our cash rate—half a percentage point below the US fed funds rate. That was a sign that there was a fair amount of confidence internationally and domestically in that we knew what we were doing. I think that has tended to weaken the idea that there is some sort of one for one link between US monetary policy and Australian monetary policy, although there still is undoubtedly a strong link between the cyclical developments of the two economies. At the moment, of course, that link has probably been weakened because we are receiving this external shock in a much greater degree than they are—Asia means so much more to Australia than it does to the US.

Mr ANTHONY—I have one final question on domestic demand. I noticed in your report you talk about the demutualisation of AMP. Access Economics said today that it could add up to half a per cent to our GDP. In your report you talk about maybe one or two. Do you still stand by that?

Mr Macfarlane—I think we said a few tenths of a percentage point. I read that as point three. We always have to be a bit cautious—we do not want to exaggerate things. If Access Economics is saying half a per cent, we are saying point three. I regard those two numbers as being very close together.

Mr MUTCH—You said earlier that Australia is the only country, other than Japan, to be part of all three aid packages. Does this suggest that some countries with the capacity to help have been dragging the chain or is it that Australia has been overly generous in this regard?

Mr Macfarlane—I certainly do not agree with the second one. I think Australia has a better assessment, not just of its international obligations, but of its own self-interest than do some other countries. The other thing is that we have a capacity to act which is actually quite impressive. For example, a country that was missing from the Thai package was the United States. Basically, they could not act in time. It is even unclear now just how much capacity they have with their very different system of government from ours. They are even having trouble getting Congress to accept that the United States should pay its regular subscription to the IMF; that is, not even the special support packages but just its regular subscription.

I have to say in passing that not only were we able to act quickly but also the bipartisan support that was received in Australia was extremely impressive. If you want a testimony to the health of Australian

democracy, you could read the debates in the House when the appropriation bill was introduced. It is not as though it was without dissent—there was a dissenter; that is perfectly reasonable—but the speeches from both the government and the opposition on the subject were extremely impressive and certainly much better informed than anything you would ever hope to hear in the US Congress.

Mr MUTCH—Which countries are dragging the chain?

Mr Macfarlane—I am not saying anyone is dragging the chain. The Thai one was the one that required speed. We had the speed and we got in there. The problem with the Thai package was that Malaysia, Indonesia and Korea were in there, but by the time we got to the later packages, some of those countries actually had their hand out rather than being in a position to be a contributor. That is one of the reasons why you cannot really blame Indonesia for not being in the Korean package or Korea for not being in the Indonesian package.

CHAIR—On the IMF issue, what exactly were the misgivings you had about the treatment of Indonesia? How would you define the sorts of boundaries that the IMF should have in dealing with a country like that?

Mr Macfarlane—We have a very high regard for the important role that the IMF plays in the international financial system. We regard it as being essential, and we regard it as probably being essential that its role has increased. We are not in the group of critics of the IMF who want to reduce or diminish its role. Far from it, as we think it has probably got a bigger role to play in the future. We appreciate, too, the fact that they were able to get their act together quickly and they were able to come in with the support packages for Thailand, Indonesia and Korea. Those packages could not have gone ahead without the IMF, and all countries accepted the condition that the IMF would be part of them.

Our only reservation really has been how stringent and how broad some of the conditions have become over very recent years. Traditionally, the IMF's role was to address balance of payments or currency crises, and it did that through a very plain vanilla approach of lending some money and imposing conditions on monetary and fiscal policy. Some time ago, it added a third area, which is imposing conditions on restructuring the countries' banking and financial systems, with better prudential supervision, closing insolvent institutions, et cetera. We think that is a very useful and important additional string to their bow.

We were a little surprised at how broad and stringent some of the conditions have now become. If a country goes to the IMF, it is not just fiscal, monetary and financial system stability conditions that are imposed; there is a much wider range of things. They have all sorts of rules about corporate governance. They have all sorts of conditions that have to be met on breaking up monopolies and cartels and all sorts of conditions on opening up domestic industry to international trade, removal of tariffs and quotas, and various conditions on removing any restrictions on foreign ownership.

I would regard most of these things as probably quite good in the long run. Most of the things that have now been added into this wider list are quite good things, but the problem is that they are so wide ranging that it makes it very difficult for a country to reach a quick agreement because they are being asked to transform the whole economy rather than just the traditional policy levers that they were expecting, so it

makes it a very slow and tortuous process for countries to reach agreement.

The problem is that quickness or speed is important. If you are in a currency crisis, every day that goes by capital outflow is occurring, your exchange rate is going down, the markets are very jittery, they know you are in the hands of the IMF and they are not going to be reassured until an agreement is reached. It is very difficult to get countries to agree to such a wide-ranging set of transformations. Some of the things that they have to sign up to are things that took us decades or more to reach agreement on here.

As you know, in the Indonesian case, Indonesia and the IMF discussed it and argued about it. The Indonesians signed up and then they decided that they did not really want to sign up, and the IMF came back with another one. I am not suggesting for a minute that all the faults are with IMF—far from it—but I think it is an extremely difficult position for both the IMF and the country concerned to be able to reach quick agreement on things which are very wide-ranging, fundamental changes to the whole way they have operated for 30 or 40 years. These tug of wars go on for a long time. Whilst the Indonesian tug of war was going on, the rupiah fell from 3,000 rupiah to the dollar to 12,000 rupiah to the dollar. It is a very painful sort of process.

I think the IMF are reasonable people and I think, particularly in Indonesia, they realised that there was a need for flexibility, but I think there were a lot of people who were pushing the IMF the other way. There were a lot of countries that were taking the opposite view. They were telling the IMF, 'Be tougher. Don't make any concessions. We are not going to put up with this.' In my view, they were tending to push the IMF into a more inflexible stance than was ideal for the circumstances. That is why the Australian government decided that we ought to be a counterweight on the other side and try to urge a bit of flexibility, and that is what we did over the period from about February onwards.

We had to get the message across. The first thing in getting the message across was to accept that what had happened in Indonesia to date had been a disaster. It was not just a typical situation of IMF having a bit of trouble reaching agreement with a member country. That happens all the time; there is always a little bit of trouble. But what had happened in Indonesia had actually been a disaster. We could not find an example anywhere in the history books of a country who had had their real exchange rate collapse as quickly as the Indonesian one had.

We also wanted to bring home to the Washington community, which is not just the Americans but the G7 community there, just how serious the likely social and economic costs were in Indonesia and how they were getting worse. This is the Australian government I am talking about—the Reserve Bank only played a very small role. I think the Australian government was very helpful in actually getting a few others to join in. Some of the Asian countries decided to speak up and they came out of the woodwork. It was a very useful counterweight to some of the major countries, who were adopting a very tough stance. I think some of these major countries really were so far removed from Indonesia and their knowledge of Indonesia was so very small compared to Australia's knowledge of Indonesia that it was important for us to get in and do that.

I actually think that at the end of the day the IMF benefited from that, and I think Michel Camdessus was quite right and genuine when he said on his recent visit here that he appreciated the intervention by the Australian government. I think it did help to bring a bit of reason into the situation.

CHAIR—Could there also be a problem that there is a presumption that the solutions being offered are necessarily the correct ones or the best ones? We have such a range of things being—

Mr Macfarlane—I think there are two types of solutions or conditions that are imposed. There are those that go directly to the heart of the problem. The heart of the problem is an exchange rate which is plummeting to such an extent that all the imported goods into Indonesia will become so expensive that no-one will be able to afford them. The big problem was the plummeting exchange rate. So there are a series of policies that are directed towards trying to stop that crisis. They are the three that I mentioned: fiscal policy, monetary policy and policies about the solvency of the financial system. We by and large agree with what they were proposing to do there. There are some differences of opinion about fiscal policy; I think they were a bit ambitious at one stage. But basically we by and large agree with that.

There are a whole lot of other policies, the ones I mentioned above, which may be good things, but they are good things in a very long run sense. They are not needed to get immediate solution to the crisis. They are things that may be helpful but they are not really crucial. Some of these things about freeing up international trade and freeing up ownership rules and all those sorts of things are good things in the long run, but some of those were the stumbling blocks. It is very hard. Let me give you an illustration. One of the conditions was that all tariffs and quotas on automobiles be removed—not immediately, but an agreement to remove those. We have not been able to make up our mind on that situation—we have been arguing that case for 30 years in Australia, so it is very hard to expect someone to quickly sign up to a thing like that.

Another one was the removal of all tariffs and quotas on the importation of commercial ships. Some of you may know that Australia cannot sell a commercial ship to the United States because there is a prohibition on the import of commercial ships in the United States known as the Jones Act. I am just bringing this up as an illustration of the fact that you really are asking countries to pretty well instantly agree to things which are very wide ranging in nature. Our feeling was the ones that impacted directly on the exchange rate, the capital flow, balance of payments—yes, they were basically right. And the other ones may well have been right but they were not urgent, and it was better to get agreement on the urgent ones.

Mr LATHAM—When you say there was a government decision to support your role as a countervailing influence on the side of flexibility with the IMF, was that not contrary to the advice of the Department of the Treasury, and how are those sorts of tensions resolved within the decision making structures of government? Further, what you have just said about markets and trade in Indonesia, is it not in Australia's national interest to pursue clean markets in Indonesia? Why should our exporters have to go through corrupted markets? Why should our investing companies have to go through crony capitalism? Isn't there a national interest argument for Australia to force those things home to the Indonesians to clean up their act, just as, if there was IMF intervention in the United States, we would ask them to abolish the Jones Act?

Mr Macfarlane—They would not.

Mr LATHAM—Well, they would or they would not get the IMF support.

Mr Macfarlane—The answer to the first one is: the opinion of everyone who has been involved in this has changed in the course of how the thing has evolved. Government's policy on these things is a result

of input from the Prime Minister, the Minister for Foreign Affairs, their departments, the Treasurer, the Treasury and the Reserve Bank. Our views have all sort of evolved through that period but there is certainly total agreement at the moment, and there has been for some time, on the approach that the Australian government has taken.

The second question you asked is: isn't it in Australia's interest to get rid of import quotas and tariffs and things like that? Yes, it is in our interest. That is why I do not disagree that these things are good things in the long run, but I think you have just got to be reasonable and recognise that most of these changes take decades to occur. They took decades to occur in this country, took decades to occur in a number of other countries—in many developed, industrial countries they still have not occurred. Sure, we should do what we can to encourage liberalisation, and I have no doubt that in the fullness of time a lot of this liberalisation will occur. For example, Indonesia has pretty well complete liberalisation of capital movements. But the issue is whether you should risk having a huge contraction in the Asian economy, or even possibly the world economy, because you are trying to rush through some changes overnight that it took us decades to achieve.

CHAIR—Okay. One question from Mr Causley and then we will have another break.

Mr CAUSLEY—I just wanted to follow on with the IMF—the situation you have raised. While I believe and I understand that the IMF have a valuable role to play in these areas, there is a fair belief that the Americans have an inordinate control over the IMF and, while they want to put constraints on other countries, when it comes, as you say, to freeing up trade themselves, well, it is not in America but everywhere else.

Mr Macfarlane—It is true that the US is the most influential member of the IMF. The US is really the most influential member of the world economy. The US is the only economy that really can provide a leadership role. In fact, we saw a very effective example of that, I think, in Korea when the US, essentially through the US Federal Reserve Board, did a whip-around and got banks to roll over their debt and then reschedule their debt in Korea. It is just a fact of life—the US is the one power that can exert leadership, and in any international forum the US will be the strongest member.

CHAIR—Okay. Mrs Gallus has one quick question on monetary policy, and then we will have a break.

Mrs GALLUS—I just want to clarify what you said before, Mr Macfarlane, when I asked about the downside of easy monetary policy. You came back, I think, with what effect this would have on the CAD by stimulated growth sucking in these imports. Did I understand you rightly that this was the downside that you described then?

Mr Macfarlane—That is one of the downsides. It is not so much a downside—

Mrs GALLUS—Okay. I promised David that I would keep it short. I just want to relate this to page 2 of your semi-annual statement, in which you said:

It is inevitable that the current account deficit will widen in 1998—that process is already well under way. A short-term

widening of this nature does not reflect inadequacies in current economic policies and, in itself, is not an issue of direct concern for monetary policy.

I am just trying to pick out what you are saying here. It seems there is a contradiction in what you said earlier in answer to my question and what you have in the semi-annual report on the role of the monetary policy in relation to the CAD.

Mr Macfarlane—What is in the semi-annual report is an answer to the widely held view that, if you have a widening of the current account deficit, you should raise interest rates. We do not have that view, and that is why it is not an issue on the agenda at the moment. My answer to you was that an attempt to stimulate domestic demand when domestic demand is already growing faster than trend would be in part, or maybe even in large part, ineffective because a lot of it would spill over to the current account deficit and so it would not be an efficient way of getting the economy to grow more strongly.

CHAIR—We might take a break there.

Proceedings suspended from 12.36 p.m. to 12.49 p.m.

CHAIR—Mr Willis has another question on monetary policy. I hope we can wrap this up reasonably soon, but if anyone else has got questions specifically on monetary policy that is okay.

Mr WILLIS—I wanted to follow up on the answers you have been giving to Mrs Gallus. Before I do, I want to say that you must have had some influence on the IMF in relation to the softening of the packages. I notice that when he was here he referred to the Australian government as leftish, which perhaps means he does not know an awful lot about Australia but must also reflect the impact of the submissions that were made to him.

In relation to the issue of whether or not there should be an interest rate cut in current circumstances, you have said that that would most likely lead to an increase in the current account and would probably have more effect there than it would on growth and therefore would be an undesirable policy to pursue. Some commentators have said that, if there were to be a further cut in interest rates in current circumstances, this would actually help with the current account in the medium term because it would bring about a further devaluation and that is the key to correcting the current account deficit in the medium term. What would you have to say about that?

Mr Macfarlane—We have said that the Australian dollar has behaved in a reasonably textbook fashion. According to what I listed of the various measures of it, it has gone down. This is part of the adjustment process and we have not been complaining about it. On the other hand, it would be a very dangerous strategy to hope to deliberately influence the exchange rate in a particular direction by a particular degree by changes in interest rates. That would be fraught with a lot of danger if you tried to do it that way.

Obviously, we have been prepared to put interest rates up and put interest rates down over recent years. On each occasion there is some sort of implication for the dollar and we accept that as one of the broader considerations when making a decision on monetary policy. But I think to narrow down the monetary

policy decision to 'let us do it because we want to affect an exchange rate in a particular direction or by a particular amount' is dangerous, particularly if you are in a situation where you are in very tumultuous times where you have had lots of very big movements in capital and where you have had a lot of difficulties in your region with capital flows and instability in foreign exchange markets.

Mr WILLIS—In the past, when we have had circumstances where we have wanted to improve confidence in the Australian dollar by getting the dollar up, we have raised interest rates to do that. Are you saying that does not work on the other side?

Mr Macfarlane—I think the one you are referring to is the one that I was referring to. That was a period when the Australian dollar was actually plummeting and it was going down to levels that were lower than had any economic logic. Indeed we did that: we raised interest rates to stop what we regarded as an unhelpful situation developing. That is very different from the situation that we are facing now.

Mr LATHAM—On 29 April, the day of her appointment, your newest board member, Jillian Broadbent, indicated on ABC Radio that she had a bias towards easing. She went on to say that:

. . . you'd have to say the employment issue is more important than prices because we haven't had a concern about inflation for some time, but there's still an employment situation which isn't satisfactory.

That was in response to a question about the dual objectives of the bank: the maintenance of full employment and the stability of the currency. Is it reflected in bank policy that you are now giving the employment issue greater weight than the prices issue? If not, what is the situation? Has the bank any arguments for why those dual objectives should be changed in the legislation in any way?

Mr Macfarlane—There are a few questions there. I think our newest board member was led a little bit further than she probably intended to go in that questioning. On the other hand, what she was really saying was something which I have said before and which, if you say it properly, makes a lot of sense in that in the very long run we have had a lot of imbalances to sort out in the Australian economy. One of the imbalances—if you go back—was a very high rate of inflation and to a large extent we have got that under control. We believe that over the nineties inflation has averaged 2.6 per cent or whatever it is and we think it is going to fluctuate around that level, whereas the unemployment rate was 11.4 per cent or something at its recent peak and is now down to 7.9. So in any medium-term sense you have to agree with the proposition that there is still more work to be done on unemployment. We have changed our institutions and our policies successfully enough to get inflation back on a reasonable track and we still have a lot further to go on unemployment, but that is not a statement about the needs of monetary policy next month; it is a general statement about our whole approach to economic policy.

CHAIR—Are there any other questions on monetary policy?

Dr SOUTHCOTT—Yes. It goes back to the current account deficit and you mentioned you have projections of the current account being 5½ per cent to six per cent. Foreign debt in Australia has remained fairly stable over the last 10 years at about 40 per cent of GDP. If we are going to have the current account deficit running at six per cent of GDP, you must be concerned that we are going to see some growth in our

foreign debt levels as a percentage of GDP. What sorts of risks does that involve for Australia? Does that have the potential, if we go up to, say, 48 per cent of GDP, of increasing the structural component of the current account deficit?

Mr Macfarlane—That ratio of net foreign debt to GDP is something that is followed very closely in Australia. It was followed intensely in Australia in the 1980s, and for good reason because it started at almost zero—maybe five per cent—in the early 1980s and then went, in the space of about 2½ years, up to about 30 per cent. That alarmed nearly everyone and that is what put foreign debt on the agenda in the Australian economic discussion.

The fact is, however, that the arithmetic that underlies that ratio was working very much against us in that time. The arithmetic is that if you have a constant current account deficit the debt to GDP ratio does not go up forever more: it flattens off at a particular level. That is really why, after that rapid rise in the mid-1980s, it quickly reached about 40 per cent and has been sitting in the low 40 per cent area—41 per cent or 42 per cent—now for the last 12 years or so. I would not expect that ratio—it may go up a bit—to vary a great deal from where it is now. I do not think that that will turn out to be a huge cause for alarm but it does not mean that some people will not take a great interest in it.

I think the other thing that has happened since that time is that there were no good figures on the external debt to GDP ratio for developed countries. During the 1980s, I think we all assumed that we had the highest ratio because we were the ones who talked about it most, but when you actually look at the figures—there are official figures put out by both the OECD and the IMF—sure, we are in the top quartile but New Zealand is a lot higher, Canada is higher and Sweden is higher. It is not as high a profile issue as it appeared in the early 1980s because, in the early to mid-1980s, people thought it was going to grow exponentially and become totally unsustainable. It hasn't; the opposite has happened. It is flattening off at a ratio which, whilst high, is not alarming by international standards.

Dr SOUTHCOTT—In your statement you mentioned that the current account deficit is in response to external conditions, and that there was nothing that Australian economic policy could do to prevent that worsening. You also mentioned in response to Mr Willis's earlier question that we had already seen a devaluation on the import weighted TWI of about six per cent. Are you confident that that devaluation we have seen will be enough to correct the cyclical widening in the current account deficit? Also, how sensitive does the bank's research indicate demand for imports is to a devaluation of the TWI?

Mr Macfarlane—I am not confident, on the question you asked, that any particular specified number is the right number for the depreciation of the exchange rate. I would be very foolish to speculate on it in public.

CHAIR—We will have one last question on monetary policy from Mr Anthony and then we might move on to some of the other issues.

Mr ANTHONY—You mentioned the current account deficit might expand up to six per cent. At what level for a developed country like Australia do the bells start to ring with the current account deficit—what percentage of GDP?

Mr Macfarlane—I do not know the answer to that, either, because I think whether the bells ring or not is largely a function of how you got the current account deficit. If you got a current account deficit because people thought you were running irresponsible fiscal and monetary policy, then the bells could ring quite early. If in fact you have got that because you have got a domestic economy which is in quite good balance, your fiscal and monetary policy are in good shape, but the current account deficit has widened because of an unavoidable contraction in your export markets, my belief is that the international and domestic markets will be much more understandable in those circumstances. So there is not a particular level where a bell starts to ring. It depends very much on the nature of the current account deficit.

CHAIR—We might move on. There are a number of issues, and hopefully we can follow them fairly quickly. We want to look at supervision, APRA—if we can get on to that—the year 2000 problem, the payment system and maybe even small business lending. I flag them and we will see how far we get with them. I might fire off the first question. On the year 2000 problem, the Chairman of the Stock Exchange has made some fairly dire predictions. I was wondering what work the bank has been doing to try to ensure—at least from the bank's perspective with other banks—you can minimise or hopefully reduce the problem that could occur.

Mr Macfarlane—I will be happy to answer that, but I have got two people sitting on either side of me who are more closely involved in that. Do you want to start off with the broad picture, Steve?

Dr Grenville—It is obviously a very important issue and it is good to have the opportunity to air it a bit. I think that is what Maurice Newman is doing, drawing people's attention to it, because there is a lot of work to be done. As far as the bank goes, there are really two separate issues on our minds. One is to make sure that we are okay ourselves—and I will talk about that a little bit. Then we also want to make sure that the financial system, particularly the banks, are in good shape. I will pass that to Graeme Thompson.

On the first one: are we okay ourselves? It is always going to be a matter of looking at priorities and what are the core systems. For us, the core system is the payment system and we are just going into a new payment system, the RTGS, which will be in place around the middle of the year. That has been recently built, so we are confident that that will be compliant.

At the same time we are looking at our other systems, we are members of committees and so on. I think that on the things we are involved in, we are confident that we are compliant and there will be room for testing, which is the other important issue. Not only do you have to get your systems in place, but you have got to leave room for them to be tested.

There is one issue though that I think probably would be worth spending a minute or two on. It is just a tiny detail in a sense, but it illustrates some of the difficulties of the year 2000 problem. One of the things we will have to decide is how much currency is around, because there may be concerns that people will not be able to withdraw from ATMs, and issues like that. It is very important, before we get to the year 2000, not only that systems be made compliant and that they work, but also that people must be told that they are going to work and must be confident they are going to work, otherwise they will take actions which, in a sense, will make the problem much worse. So when we look at the year 2000 problem, it is very important that people understand it and address it, and address it in good time to fix it. But it is also important not to

run any kind of extreme scare tactic because, at the same time, people will take actions which in a sense will make the problem worse. This is the balance we need to sort out over the next 12 or 18 months.

In terms of the banking sector and so on, it will be important that, as we get closer to the year 2000, the banks and the Reserve Bank make statements that will give confidence that the core systems are going to work. I think that is what we are looking to. Not only have you got to fix the problems, not only have you got to make sure that your connections with others are not going to trip you up, but you have got to make sure that people in the community understand that we will be ready. We are confident that we are on that track; it will take a fair bit more work yet, but we are confident that we are on that track.

CHAIR—Just on that point, Dr Grenville, are you saying that you are confident that you can prove Mr Newman wrong, from the banking perspective anyway?

Dr Grenville—I do not think he is making specific statements about what will work and what will not work. Given the lawyers who are waiting in the wings rubbing their hands at the possible actions that they might take about anyone who has given any guarantees, I think he wants to make sure people focus on it and get along with it while there is still time to fix it. That is a very important job, and I think he is doing a good job in that regard. I do not think he is saying that we, or anyone else, will not be ready. I think he wants to get people to focus on it.

CHAIR—Can I just clarify one other point? You mentioned something about cash around in case ATMs are not working. Could you just expand a little on that? I would have thought ATMs are fairly recent. Do they have a problem in the year 2000, too?

Dr Grenville—No, there are no problems with ATMs. I was trying to make a point about the fact that it is important the information be clear and that people do not take actions which are unnecessary. The point I was trying to make was one about the fact that it is not only important that things like ATMs work, which they will, but it is important that people understand that they will work.

Mr Thompson—To complement what Steve said, I will just report briefly on what we are doing with the banks themselves. Obviously, there are overlaps with what Steve has talked about because a lot of our systems interface with the systems of the commercial banks. In May last year we first started to turn our attention to this issue, as far as the banking system was concerned, in some detail. We surveyed all the banks about their level of awareness and the level of preparation that they were engaged on to address the year 2000 problem. We reported publicly on the summary results from that survey. I think it is fair to say that what we saw there was a variable picture. Some banks were well advanced in addressing the problem; others were not so far along.

Since then we have spent a lot of time talking with the banks as part of the usual prudential consultation process about how their programs have progressed since May last year. The particular task that we are having the external auditors of the banks do this year as part of our supervision process is to give us detailed reports on each bank's business continuity and contingency planning arrangements, which obviously covers the year 2000 as well as other things. So there has been a lot of attention given to the issue in our normal relationship with the banks.

Just in the last month we have gone back to them with another comprehensive survey across all the banks, which is a follow-up to the one we did last year. The aim of that is to assess across the whole system how much progress has been made over the past 12 months or so. The results of that particular questionnaire are beginning to flow in to us now, so we will be in a position fairly soon to make another comprehensive assessment.

Without wanting to prejudge things, I think we will be able to form a judgment that, at least in relation to all the critical systems—the ones that really have to function well—the banks will be fairly well placed to have those, in the jargon, remediated by around the end of this year, so there will be a good deal of time for testing and contingency planning, if necessary, through 1999. But we will be reporting publicly on the results of that second survey.

Mr WILTON—Mr Macfarlane, you cited in your semi-annual statement that the Cullen Egan and Dell survey reveals that executive salaries continue to grow at around six per cent and that wages generally are something a little less than four per cent. Have you been able to calculate the contribution of executive salaries to total wages growth?

Mr Macfarlane—Thanks for bringing that up. That request, I think, was made to the previous meeting for us to have a go at it.

Mr WILTON—It was, yes.

Mr Macfarlane—We have had a go at it, and I do not think what we have come up with is all that brilliant. But here is a document which I am happy to give to the committee.

Mr WILTON—That would be great.

Mr Macfarlane—You can make it public if you wish. It is really more of a survey of the various attempts to do it. It is very difficult because, first of all, it depends on how you define an executive. You can get very different results depending on how they are defined. One of the two definitions that seem to be going around the most is one that I think the Commonwealth used in a submission recently where you define an executive as someone who earns more than $100,000 in ordinary time wage and salary earnings. If you do that, you get about 11,000 people who qualify as that. If you look at what their average earnings are and then you look at the rate of increase in their average earnings, the contribution that makes to AWOTE is still quite a small number. It is only half of a tenth of a per cent—so it is 0.05. That is because 11,000 is a small number.

The ACTU have a different definition. It sounds very similar, but is actually quite different. If you define an executive as someone who declares $100,000 as their taxable income on their group certificate—that would include overtime, retrospective pay, allowances and what have you—you will get 75,000 people who will be classified as executives. It is seven times or so as big, so the effect you get is about seven times as big. So if you do it that way, you get a contribution to AWOTE of 0.4.

We really have not been able to do anything more profound than to survey the attempts that other people have made. That is what is in that document.

Mr WILTON—Thanks for your honesty, and for preparing, or at least having a go at preparing, an answer to the questions that have now been asked on two occasions. I have one concluding question on the AWOTE issue. What was your view on the commission's recent living wage decision?

Mr Macfarlane—It is getting very difficult here. I have to give an opinion before the decision and also give one after the decision. I think that it does not cause me any concern. It seems to me that it will contribute at the aggregate level—to other things being equal—maintenance of wages growth, which is not out of line with our inflation objective.

Dr SOUTHCOTT—At the last public hearing, the Reserve Bank had some concerns about declining lending standards by the banks. I just wonder whether those concerns are still held, and what the Reserve Bank is doing about it at the moment.

Mr Macfarlane—Concerns about declining lending standards are very much associated with my colleague over here on the right, so I will let him answer that question.

Mr Thompson—I think it is true to say that we are less concerned than we were a year or so back. Perhaps partly in response to some of the comments we made, I think we have seen evidence of the banks tightening up procedures in a few areas where they looked a bit loose.

Another particular source of concern was the fact that margins on large corporate loans had been squeezed to what looked like very fine amounts. In the last couple of months we have actually seen those margins move back out again against the trend of what has been happening in other parts of the market. That seems to be a reflection of the withdrawal of some international banks from syndicated lending in this market. So I think that is probably a healthy development.

The short answer to your question is that, at the moment, we do not have any serious concerns about asset quality. Aggregate impaired loans of the Australian banks have either been steady or have possibly even been falling slightly in aggregate over the past six months or so. The ratio of those impaired lines to banks' total assets is about half a per cent. On the basis of those figures, we are not losing any sleep over asset quality at the moment.

Mr WILLIS—Going back to wages, is it the intention of the bank in relation to future living wage type claims to make any public comment on those claims prior to their adjudication by the commission?

Mr Macfarlane—We do not have a firm policy on this but it is probable that we would not. The fact is that we have had two safety net reviews and we did make a comment before the first one. Not only did we make a comment, but we published a little piece on the subject. We did not make a formal submission and we certainly did not appear. On this one, we did nothing. The reason that we did something the first time was because it was a very different set of circumstances. Aggregate wages were still going up, AWOTE was still going up, enterprise bargains were still going up. The outcome of the aggregate level for wages was still very uncertain and the ACTU claim that was made was a very high one. We thought the combination of those two things spelt the possibility of things getting out of control, so we said something.

People then started to say that the Reserve Bank was the wages policeman, and we have always argued vehemently against that. We are not wages policemen; in fact, we are not experts on any of the detailed stuff that gets discussed at national wage cases or before the Arbitration Commission. We do not profess to be the experts in that. All we did on that occasion was essentially to spell out what we thought the macro-economic outcome from inflation would be and a wage outcome that would be consistent with that.

On this occasion the situation was quite different. We were starting to get some evidence at the aggregate level that wages were no longer going up. They had flattened out. In fact, you could make a case, although not a very strong one, that they had come down a bit. Also, we thought that the claim was much closer to reality than their claim in the previous one. So we did not see a case to get involved at all. We do not think it would have helped anyone if we had tried to butt in on that.

Mr WILTON—Were you surprised at the time of your earlier statement that excerpts from it were incorporated in the commission's then decision, despite the fact that you were not formally called as a witness?

Mr Macfarlane—No, I do not suppose we were surprised because we thought, as I said, at the time when the hearing was occurring—I think it was in about December 1996—wages and the rate of growth of earnings was a big issue. It was a much bigger issue than it is now. It was something that we had a view on. The Arbitration Commission had every right to use whatever piece of evidence they wanted to use, and they used it. So it was not a surprise that it was quoted. I would think that, in a properly operating system, they would regard the macro-economic parameters as being an important constraint on or input into their decision making. So it is perfectly reasonable that they quoted it.

Mr ANTHONY—Slightly off the track here, this committee is also involved in an inquiry into regional banks or, specifically, the lack of them. In some ways it has been a mark of failure that many Australians in regional areas have been deprived of even getting to a financial institution. I was wondering whether I could get your view on what type of remedies could be put in place. The chairman of one of the major banks gave evidence a few weeks ago that they really did not see a role in many of these communities. How do we go about providing these financial services to a big chunk of Australians who are being disenfranchised?

Mr Thompson—The bank recently provided to the committee an updated information paper on just what has been happening. It was a paper that updated a summary of the facts about trends in branch representation and other points of payment system and banking entry around the country. As you say, the facts certainly are that the number of bank branches per head has continued to decline over the past few years.

What drives that, as I am sure you have heard from the banks themselves, is really bottom-line considerations as to the profitability of conducting full-service branch banking activities in regional areas. It remains the case that there are more branches and other points of representation per head outside capital cities than there are within, but the trend in both cases is down.

I am not sure what one can do about it, other than to encourage the banks to replace full-service

branches with alternative forms of access to banking services—telephone banking, ATMs, other devices—and to facilitate, as far as possible, as far as it is within the government's control, the provision of services through other means, whether that be through post offices or through other agencies and other financial institutions.

This really is an example of the market working. The fact is that full-service branches in regional areas are difficult to make money out of. So while I can understand the inconvenience that can be caused in rural areas when branches of banks withdraw, it is not really difficult to understand why it is happening. But alternative forms of delivery are increasingly available, electronic forms, which are more economical. To the extent that they can be encouraged to be provided either by banks or by other agencies, then I think that is probably the most realistic solution to the problem.

Mr ANTHONY—Do you think it is the role of the banks to leave something behind?

Mr Thompson—I think if they want to be seen as good citizens, then it would be in their interests to do so.

CHAIR—That could be a very useful quote for the committee. Can I add two points to that response. First of all, with regard to this paper, for which we thank you, I do not think we have formally received it yet; it must be in the mail.

Mr Thompson—It is dated 4 May.

CHAIR—Okay, it is on its way. We hope that, by the time we finish this inquiry, we will be able to help you with some more detailed answers to the question as well. Mr Thompson, this is probably your area, and also Mr Macfarlane: with the change in prudential supervision that is coming through with APRA—the Prudential Regulation Authority—and the different role that the Reserve Bank is going to play, what steps have you taken to ensure that, in the transition mode, were there to be some major difficulty in the financial system, you can fully cope? In other words, as you shift from what you have got now to what you are going to have, in that transition mode, are you fully modus operandi regarding any adverse event that might occur?

Mr Macfarlane—I think the major thing we have done to make sure that the transition works smoothly is to appoint Graeme Thompson as Chief Executive Officer of APRA. It is not my decision, of course; it is the government's decision, but it is a very wise decision which minimises the likelihood of anything untoward happening in that transition phase. Another point is that the transition is occurring at a time when the banking system is in very good shape. Bad debts are extremely low by any past standards here or by international standards. So I think that also helps.

Another point is that the body of people who have experience as bank supervisors in Australia are the people who are currently working with the Reserve Bank and they will, by and large, move over to APRA. So, as far as we can see, the intellectual capital involving bank supervision will not be lost. We are not starting with a new team.

CHAIR—With that introduction, I am sure Mr Thompson would like to add something.

Mr Thompson—I would mainly want to reiterate the governor's third point there. The transition is not going to involve a dramatic breakpoint from one organisation or arrangement to another. In fact, on day one of APRA it will be very difficult to tell that anything has changed. The Reserve Bank supervisors will almost certainly remain exactly where they are for a time, as will most of the Insurance and Superannuation Commission people, and the move to an integrated agency with its own premises will take place over time. As the governor says, the people who will be involved in monitoring the health of financial institutions and dealing with any problems that arise will be much the same people who have done it in the past. I think those points, together with the fact that the financial system at the moment is in relatively good health, would lead one not to be concerned about anything falling down the cracks during the transition phase.

CHAIR—Have you given any thought as to how you might handle the problem that has arisen from time to time about perceptions of the board of the Reserve Bank and their interests, and how the board of APRA is going to be able to handle that? Will it be along similar lines or are you going to have a different way of reporting to the public?

Mr Thompson—The legislation to establish APRA says that no member of the board can be an employee or a director of any institution regulated by APRA, so there will not be any direct conflicts of interest of the kind that might arise on a regulatory board. I think the range of potential conflicts of interest relating to APRA is probably not as broad as those which come up in connection with the Reserve Bank Board, where consideration is being given to a topic as broad as monetary policy.

Given what is in the APRA act, and given the provisions of the Commonwealth Authorities and Companies Act—to which APRA will be subject—I do not see conflict of interest as being a difficult issue to deal with.

CHAIR—What about accountability to the public of the board or the authority?

Mr Thompson—The accountability provisions are somewhat similar to those of the Reserve Bank. APRA will be required to publish an annual report to the parliament and it is also required to keep the Treasurer informed of emerging difficulties or potential problems in the financial system.

As well as that formal annual reporting process there will be the continual contact between the agency and the Treasurer, as there is with the Reserve Bank. I guess it is conceivable that APRA may be invited to appear before a committee such as this as part of that accountability process, but I have not yet seen anything formal along those lines.

CHAIR—It has occurred to the committee.

Mr WILLIS—Just to follow up on that, can I ask you what numbers of staff are likely to move from the Reserve Bank eventually to APRA, and when do you see the state regulated institutions becoming part of APRA?

Mr Thompson—Approximately 65 staff will move from the Reserve Bank to APRA, which is

basically the bank supervision department that we currently have.The movement of the state based institutions—the building societies, credit unions and friendly societies—to APRA depends on action by state parliaments. So I cannot be absolutely sure when the necessary steps will all be taken. My understanding at present is that the states are working towards 1 December 1998 for the transfer of responsibility for regulation of those institutions to APRA.

Mr WILLIS—Given the role that the Reserve Bank will still have for ensuring the stability of the system, and given the concerns expressed previously by the bank about the possible need for duplication of the role of independent provincial supervisors so that it could properly carry out its role as ensurer of the stability of the system, if all of the supervisory staff are going to APRA, how is the bank going to carry out its role in regard to the stability aspects?

Mr Thompson—I might pass that back to the governor.

Mr Macfarlane—Basically, that part of system stability that involves direct face-to-face bank supervision is all going to APRA; and so we will not retain that capacity. We are not going to duplicate that although we are allowed, at our discretion, to attend any bank inspections that APRA may wish to do. If we are worried about something, we can come in and participate in that, at our discretion. The other main thing is that two of us will be on the APRA board.

You are quite right, in a sense. Our judgment on the solvency of any individual bank will be based on what APRA tells us; but we are not totally passive. If we have got some suspicions we can go in and nag them and we can go along and second-guess them. My guess is that it will not be very common. But we will retain a financial systems group, half of which have a very clearly defined role in the Payments Policy Department and, in fact, an enhanced role as a result of the Wallis changes. There will be another small department which will be called the System Stability department which will have much more of a big picture view—more of a research oriented view—of trying to work out where it thinks the vulnerabilities are in the financial system: which particular institutions, which particular markets, where the risks are. It will be small, made up probably of quite highly educated research type people looking ahead. We think that would be a very good complement to APRA, which will be the hands-on people who are talking to the industry all the time and visiting them. We do not think there will be duplication if it is done that way.

Dr SOUTHCOTT—Mr Macfarlane, how advanced is your planning for establishing the exchange of information on conduct of monetary policy from Reserve Bank to APRA, and from APRA on supervision of the banks back to the Reserve Bank? Do you anticipate any problems with passing that information on?

Mr Macfarlane—It is not quite as two way as you make it sound; it is actually one way. APRA has no particular special position vis-a-vis the Reserve Bank board. APRA will not have a representative on the Reserve Bank board, but the Reserve Bank will have two representatives on the APRA board. So APRA's understanding of monetary policy will be essentially the same as the rest of the community's understanding of monetary policy, other than if an issue comes up at an APRA board meeting of course there will be myself and one of the assistant governors there at that meeting. But the intention is that the transfer of information is essentially one way—from APRA to the Reserve Bank.

Dr SOUTHCOTT—You do not anticipate any problems? You have obviously got that board representation but will there also be a bilateral committee which will coordinate information?

Mr Macfarlane—There are lots of committees, yes. There is a bilateral committee that is going to coordinate exchange of information. Obviously, we will have to exchange a lot of payment systems type information with APRA because the members of APRA are also players in the payment system. I do not anticipate that being a problem. It might be a problem in 15 years, but it is certainly not going to be a problem at the beginning because it is very much the same sort of people who are used to cooperating with each other who will be forming the two institutions.

Dr SOUTHCOTT—Just to clarify: in the other areas of conduct of monetary policy and stability of the system, there is no formal process for exchanging information with APRA?

Mr Macfarlane—Not on monetary policy. On stability of the system, yes, there would be. The bilateral committee would make sure and, of course, there is also the Council of Financial Regulators—which not only includes APRA and the Reserve Bank but also what is currently called the ASC, which is going to be called the ASIC—so there are an enormous number of coordination devices. I do not see that that is going to be a problem.

Mr WILTON—My question also goes to coordination and perhaps one-way information flows. You have consistently expressed opposition to the possibility of publishing board meeting minutes as they do, for example, in the US and UK. If this were to be done on a non-identifying basis, would it not—by giving markets an insight into policy issues—go some way towards easing or even eliminating the likelihood of those markets being volatile? Would you even consider publishing your forecast—whether there is, say, growth in unemployment or in the current account—as several other central banks do?

Mr Macfarlane—On the first point, it is not at all clear whether publishing that sort of information would reduce or increase volatility. You would typically find that markets jump when they receive that information, rather than that information calming them down, so it is hard to make a case on the grounds that it would reduce volatility in financial markets. There certainly are people who ask for it. The press ask for it and the money market economists ask for it. I am not sure whether there really is a demand from the rest of the community for that information.

On forecasts, we believe that we give information, our view of how the future is evolving, as clearly as we honestly can. We could, of course, publish big tables of numbers of quarterly growth rates of this, that and the other going out for very long periods of time. We would not have a great deal of confidence in those numbers but certainly, as you have heard today, we have made it absolutely clear what our view particularly is of inflation, growth, unemployment and the current account and of what we think is going to happen over the rest of the year. Those figures might be wrong but they are our honest opinion of what we think is happening and we think that you are well informed on what our views are on those things.

Mr ANTHONY—This question is to Mr Thompson: in your new role with APRA, do you have a position on the managed investments bill, currently going through parliament now, which has caused quite a bit of controversy? Obviously, the huge surge going into managed funds will come, I assume, under your

umbrella or perhaps it will come under the other umbrella.

Mr Thompson—Managed funds will be regulated by the Australian Securities and Investment Commission.

Mr ANTHONY—The overall thrust of the managed investments bill will be to have one entity, rather than perhaps a plethora of trustees. What is your view on that?

Mr Thompson—I have not really followed that debate terribly closely because those institutions will not be the responsibility of APRA, but I am aware that issue has been debated very extensively and heatedly over a number of years.

It seems to me that having a single entity with clear responsibility for the proper management of those funds is probably the more efficient arrangement than the previous arrangements, where it was possible for confusion to arise as to whether the manager or the trustee was responsible for a particular aspect of the fund's operation. I certainly do not claim to be an expert on the details of that particular bill. I will leave that to Mr Cameron.

CHAIR—Don't you have a situation where a bank which also has managed funds is still going to have that split regulation?

Mr Thompson—Yes, the Wallis committee recommended—and, we believe, for a good reason—that institutions offering products that effectively had some sort of a capital guarantee attached to them should be subject to a regime of prudential regulation by APRA, but that other financial products which did not have a capital guarantee attached to them, and where investment returns were very much on a best endeavours basis by a funds manager, should be subject to a different regulatory regime that focused on disclosure and appropriate standards of governance by a responsible entity of some kind. Those sorts of investments will be regulated by the ASIC according to that model.

There is quite good sense in that model because it would not be a good outcome for people to assume that investments in managed funds carry the same degree of safety as a prudentially regulated institution that had made promises on the basis of some sort of capital guarantee.

CHAIR—I might switch to another issue: the cheque clearance system and the plans for a trial from 1 July this year so that clearance times would be reduced to 48 hours from the day after a cheque was submitted. How are those plans going? Do you expect to have the system in place by July 1999?

Mr Thompson—That is really a project that the commercial banks themselves are responsible for. My understanding is that the project is basically on time for, I think, April next year. The aim is for banks to be in a position to give value on cheques 48 hours from the time of deposit. The jargon talks about day 3, but day 3 actually means 48 hours after a cheque is deposited in the bank. As far as I know, the project is on time.

CHAIR—Does anyone have any further questions on any issues?

Mr ANTHONY—It would probably be remiss of me not to ask this question as I am sure members of the press gallery would. We have been discussing Australia as an export and import nation and, clearly, there have been some barriers to imports recently on a lot of the docks around the country. Do you expect what has been happening with the barrier on goods on the waterfront to have any impact on the economic numbers?

Mr Macfarlane—It depends on how long it lasts.

Mr ANTHONY—Currently—today.

Mr Macfarlane—At the moment we have not put any work into measuring any effect. There must be some effect. I think that the people who are looking at it say it would result in a slightly bigger shortfall in imports than in exports but it depends on how long it lasts. I am sorry I cannot give you anything more profound than that.

CHAIR—I think we have had a pretty good innings so I would like to thank Mr Macfarlane, Dr Grenville and Mr Thompson very much for coming before today's committee hearings. I assure you that this will not be the last time we have a meeting in Melbourne because I am very keen, as I know many members of the committee are, to see that Melbourne is one of the major financial centres in the world.

Resolved (on motion by **Mr Wilton**, seconded by **Dr Southcott**):

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 1.43 p.m.