COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 1997-98

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Tuesday, 15 December 1998

Members: Mr Hawker *(Chair)*, Mr Wilton *(Deputy Chair)*, Mr Albanese, Ms Burke, Ms Gambaro, Mrs Hull, Mr Latham, Mr Pyne, Mr Somlyay and Dr Southcott

Members in attendance: Ms Burke, Mr Hawker, Mr Latham, Dr Southcott and Mr Wilton

Terms of reference for the inquiry:

Review of the Reserve Bank of Australia annual report 1997-98

WITNESSES

Committee met at 10.32 a.m.

CHAIR—I declare open this public hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration. This is the first activity of the new economics committee, and I am very pleased that it is with the Reserve Bank. While we have a good mix of continuing members from the last parliament, we do have some fresh faces. I also note that under the new arrangements the size of the committee has been reduced from 14 to 10.

The Reserve Bank appears before the committee under the agreement between the Treasurer and Governor on key aspects of Australia's monetary policy framework, and the bank's *Semi-annual statement on monetary policy* forms the framework for the discussion. 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 portfolio responsibility. This takes place under House of Representatives standing order 324.

The Reserve Bank has participated in these hearings for a number of years, and the 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. As both the bank and the committee have acknowledged on many occasions, these hearings have become an important element of the bank's accountability and transparency processes.

This hearing is a little different from those in the past in that the bank's semi-annual statement was released several weeks ago, and this has given everyone the opportunity to consider that document in a bit more detail. Today's hearing will cover monetary policy, some aspects of the bank's operations and the new division of financial responsibilities, which have been in place for nearly six months.

GRENVILLE, Dr Stephen, Deputy Governor, Reserve Bank of Australia

MACFARLANE, Mr Ian, Governor, Reserve Bank of Australia

STEVENS, Mr Glenn, Assistant Governor (Economic), Reserve Bank of Australia

CHAIR—I welcome the Governor, Deputy Governor and Assistant Governor of the Reserve Bank of Australia to today's public hearing. I remind you that the evidence you give at this public hearing is considered to be part of the proceedings of the parliament. I, therefore, advise that any attempt to mislead the committee is a very serious matter and could amount to contempt of the parliament. Mr Macfarlane, would you like to make an opening statement before we proceed to questions?

Mr Macfarlane—Yes, I will, as has become my practice. I thank you for your kind words of introduction. As you mentioned, the need to make adjustments to the committee after the October federal election means that we are meeting about five weeks later than we normally would. Given the uncertainty about the timing of this hearing and the importance we attach to regular communication with the public, we decided to keep to the regular timetable for releasing our *Semi-annual statement on monetary policy*, which I have here, which came out in early November. There is a substantial gap between the statement and this hearing which, as you mentioned, at least gives you the advantage of being able to read it at leisure, rather than trying to read it in the space of an hour, as is normally the case.

On the whole, we feel that despite this gap the statement still represents a reasonable summary of our views on events that have taken place over the preceding six months. The world has not changed that dramatically since the statement was issued. We have, however, made an adjustment to the stance of monetary policy following the December board meeting. That is not covered in the semi-annual statement. This change of monetary policy was a result of our continual process of evaluating incoming information and our assessment of the outlook for the year ahead and the various risks that were attached to our forecasts. Our judgment was that, even though most of the data coming in was still suggesting good growth, the likelihood was that growth would decline in 1999 and, at the same time, the likelihood of overshooting the inflation target was judged to have declined. Hence, we viewed a small further easing of policy as a prudent measure.

The economic outcomes over the past year have been pretty good. I suspect that that will be a recurring feature of our discussion today. It might be helpful, therefore, if I keep to my usual practice and start by reviewing the forecasts that I presented to this committee seven months ago and make some observations about how recent developments have panned out compared to what I thought was likely to happen.

Last time when I was in front of this committee I summarised the outlook for the rest of 1998 as being as follows: I thought GDP would grow by about three per cent during 1998, that the unemployment rate would remain relatively stable, that we had passed through the trough of inflation and that it would rise gradually, reaching about two per cent by the end of the year, and that the current account deficit would average about 5½ per cent of GDP in 1998. I also said that I thought this combination of events would be a reasonably good result for Australia in view of the difficult external situation we were facing, particularly among our Asian export markets.

In the event, the external situation did not get any better, but Australia’s economic performance has exceeded our expectations and, to the best of my knowledge, the expectations of virtually all forecasters. It now looks as though GDP growth during the course of 1998 will be about four per cent, rather than the three per cent that I had suggested seemed likely in May. In May we did not have any of the quarterly growth rates, so we did not have any of the four quarterly growth rates for 1998. We now have three of them.

A good deal of this additional growth is attributable to the stronger outcomes that occurred in the March, June and September quarters. The remainder is a result of an upward revision to earlier data across most of recent quarters. Consistent with this stronger than expected growth, the rate of unemployment has continued to edge down rather than staying flat. Over the past three months it has averaged 7.9 per cent compared with 8.1 per cent in the first quarter of 1998 and 8.7 per cent in the first quarter of 1997.

On inflation it seems clear that the trough has passed and our best guess for the rise in the CPI over the four quarters to December 1998 is, in round figures, still about two per cent. It is also true that inflation does not show signs of increasing as much as historical relationships might have led us to expect given the fall in the exchange rate. On the current account deficit, it now looks as though it will average about five per cent of GDP in 1998, rather than the 5½ per cent we expected at the last hearing.

I would summarise the situation as being one where the forecast errors were within the normal ranges that occur with forecasts of this type. The thing we can take some comfort from, however, is that no-one can accuse us of being pollyannas because in each case the outcome was slighter better than we had forecast.

I now propose to make a few general comments about how we are expecting future events to unfold. Over the course of the year, before the Asian crisis commenced—that is, in 1996-97—the economy grew by 4½ per cent. That is two years ago. In the first year affected by the Asian crisis, 1997-98, it grew by 4¼ per cent. Despite starting 1998-99 at a similar pace, we have to accept that we will not be able to continue at this rate. Growth through 1998-99 is more likely to be somewhere between 2½ and three per cent. Implicit in this is that coming quarterly growth rates will be noticeably lower than the ones we experienced over the past year.

Some slowing seems to be inevitable given the weaker outlook for the world economy. Since we last met in May, most forecasters have revised down their expectations. The IMF, to take just one example, has revised down its forecast for world growth in 1998 from three per cent to two per cent and for 1999 from 3¾ per cent to 2½ per cent. So it sliced a full percentage point or more off the current year and the next year. If these estimates are a reasonable guide, then the external environment will remain difficult and income from external sources will be constrained.

Of course domestic demand has been and remains much stronger than external demand, so Australia’s expenditure has run ahead of national income over the past year. But that gap cannot be expected to continue to grow at the same pace indefinitely, so both domestic demand and GDP growth must be expected to come down over coming quarters. With slower growth in the offing, we expect the unemployment rate will flatten out. Of course we said that last time. Now we are suggesting it will occur at a slightly lower rate of unemployment than we formerly expected.

We expect the four quarters ended increase in the CPI to be about 2½ per cent by the end of the financial year—that is, we expect the inflation performance to be consistent with our target. Of course any forecast of inflation beyond that period is only as good as its assumption about the future path of the exchange rate. Given the current tendency towards lower commodity prices, we are assuming some further widening in the current account deficit to about 5½ per cent of GDP in 1998-99. With an annual figure of this size, it would not be surprising to see a quarter or two of it running at over six per cent. I made the same comment in March this year and again in May at our previous hearing. I expected it would have come to pass by now, but it has not. But it would surprise me if it does not happen at all.

This set of outcomes or something like it would represent a good performance for an economy in its eighth year of expansion facing a difficult but not disastrous external environment. I expected that it would be well received by the domestic and international investment community and no-one can ever take this for granted. Of course, if the assumptions we are making about the world economy turn out to be too optimistic, then all bets would be off.

I now come to the second part of my testimony in which I will attempt to answer the question of why we have done better than most other countries in Asia or the Pacific Rim. In doing so, I am conscious that the story is not yet over and that this is really an interim report. I think a number of factors have been involved, and I will list them in no particular order. As we go through them, it will become apparent that they are in fact all intertwined.

First, I think the Asian crisis hit at a time when the Australian economy was in good shape partly for cyclical reasons. By mid-1997 the economy was growing strongly and inflation was lower than our target. Had we not received a contractionary impulse from the Asian crisis, we may have been facing the need to tighten policy because of a potential overheating. No-one will ever know the answer to that, but it certainly would have been a possibility. I also have to mention that I am conscious that attributing our performance over the past 18 months to our good starting point is rather superficial because it does not explain why the starting point was so good, but I think some of that will come out as I go through the other points.

Second, I think we have benefited a lot from the flexibility of our exporters who have switched from the contracting Asian markets into the expanding North American and European ones and into a number of other markets we do not usually think of as being important to us. The nature of our exports, with so much of them being commodities, has helped, but the efforts of our marketing companies and authorities should not be ignored. Even with all this effort it has not proved possible to prevent exports from falling, and over the year to the September quarter, which is the latest year we have, the volume of exports fell by two per cent.

Third, Australia has benefited from a greatly improved perception of the soundness of its economic policies. The fact that the budget has moved back into surplus where it should be in the mature phase of an economic expansion has been important; so is nearly a decade of low inflation. Also important on this occasion has been the recognition that Australia scores well on such financial infrastructure factors as the regulation of its banks, the regulation of other financial institutions and stock exchanges and that its underlying body of commercial law and accounting practice is at or close to world best practice.

Not only have the international capital markets taken a better view of Australia, but we also seem to have more confidence in ourselves. Business and consumer confidence initially fell as the Asian events unfolded, but they did not fall excessively. For the most part, they fell from being well above average to being about average. In the past three months they have tended to rise moderately again as figures about the economy have confirmed that it has performed better than most people had expected.

The fourth explanation for why growth has held up is a catch-all one. The economy just seems to be more flexible and adaptable than before. The only clear evidence of this is that productivity, whether measured in terms of labour productivity or factor productivity, has increased faster in the 1990s than in earlier decades. For example, total factor productivity has increased at an average annual rate of 1.7 per cent during the expansion of the 1990s. I think the numbers in the printed text here are wrong. It should be compared with 0.7 per cent in the 1980s and 1.2 per cent in the 1970s. But it is a significantly faster increase in productivity in the 1990s than in the previous two decades.

To me this suggests that the painful adjustments that have been made over the past decade or so are paying off. By this I mean the changes that have been made to increased competition in previously sheltered industries. This of course includes greater export orientation but also greater competition in utilities and transport, which has reduced costs to other industries. It also includes the downsizing of the public sector, which has released resources. Finally, our labour relations practices and wage setting machinery have evolved a degree of flexibility that has surprised the sceptics.

I now come to the fifth factor which most commentators view as being extremely important, and so do I—namely, the fact that in response to a contractionary external shock the Australian dollar was allowed to float down. This is the way the textbooks say the situation should be handled and is in sharp contrast to the severe domestic squeeze that can result in the case of countries with fixed or quasi fixed exchange rates.

The domestic economy has benefited as a result of the lower exchange rate because exporters' incomes have been held up and the incentive to export has been maintained while at the same time assisting those industries that are competing against imports. The domestic economy has also benefited because we have not had to put up interest rates in order to maintain our external parity, as you would if you had a fixed exchange rate, or to prop up a floating rate that threatened to fall so far that it would have had undesirable inflationary consequences. We have not had to raise interest rates for either of those reasons. Raising interest rates in response to an external contractionary shock is not something you would normally want to do, although in extreme circumstances it can become necessary.

I have heard some people say that it is a good thing that, unlike some other countries, we were relaxed in the face of a falling exchange rate. I can assure you all that we were never relaxed. Having followed the Australian dollar on virtually a daily basis for 15 years, I know you can never take it for granted. While the floating exchange rate is the best system we have had or are likely to have, like all asset prices freely determined in unconstrained markets, the Australian dollar is prone to bouts of instability or overshooting. On three occasions in January, June and August, a downward overshooting threatened and we responded with foreign exchange intervention. On each occasion stability was re-established and, unlike the experience of the mid-1980s, we did not raise interest rates. But this does not mean that that option was not on the table. It was, and financial markets knew this. As a result, 90-day interest rates were well above cash rates in both June and August. Fortunately, things turned out well, so the option did not have to be used.

Thus the exchange rate was centre stage. The general direction of its movement was performing a very useful function, yet the short-term dynamics were such that it often threatened to go too far. It has been a delicate balancing act, but one with a favourable outcome. Over the past two years the economy has been able to grow at over four per cent per annum without significant upward pressure on inflation, which has averaged 1.6 per cent over the same period. This is better than almost anyone expected.

Another way of approaching the question is to ask: why were we at the Reserve Bank able to accept this continuation of high growth and depreciating exchange rate without having to tighten monetary policy brackets—in fact being able to ease it slightly at the beginning of this month? The answer is that the combination of this fast growth and the fact that the exchange rate has gone down has not seriously threatened our inflation target. Why has it turned out this way? The answer, I think, is that we are beginning to receive the big dividend that low inflation provides.

The economy has gradually adjusted to nearly a decade of low inflation and, although the adjustment is still not complete, the benefits are becoming apparent. Inflationary expectations are much lower and more stable. Wage contracts are now often for two or three years duration. Loans, including housing mortgages, often have interest rates fixed for as long as five years. Businesses know that they can no longer automatically pass on any cost increase, secure in the knowledge that it would get lost amongst the multitude of other price increases occurring.

This new less volatile environment allows the floating exchange rate to do its job of stabilising the domestic economy in the face of an external shock. The low inflation environment does so by reducing the tendency for the expansionary effects of a falling exchange rate to be dissipated in the form of rising inflation. It also goes without saying that the low inflation environment makes the task of monetary management a lot easier.

I think we can take some satisfaction in how events have turned out over the past two years, but we should not become complacent. This particular episode, which started as a regional Asian crisis, is far from over. We should not think that we can see the end of it just because it has already been running for 18 months. For a start, the United States has only recently started its slow down, and uncertainty about the US outlook seems greater at present than for some time. In addition, Japan remains gripped by powerful contractionary forces that could put continued downward pressure on commodity prices, as we are seeing at the moment. Much has been said recently about how Asia has passed the worst of its problems and on a number of measures, particularly those pertaining to financial markets, this is so. But the contractions they have suffered have been extremely severe and no-one, I do not think, is expecting a quick or strong recovery.

I do not wish to say any more at this stage. You will note that I have dealt exclusively with the domestic economy, but I think that is appropriate since I have spoken so much recently in other places about Asia, the world economy and international financial markets. My colleagues and I are, of course, happy to answer any questions you may have on the topics I have not covered or, for that matter, on the ones I have. Thank you.

CHAIR—Thank you very much, Mr Macfarlane, for that very comprehensive, up-to-date assessment of the way you see the current state of the Australian economy and the Reserve's position on a number of the key indicators. I guess the temptation is always there. We are 10 days from Christmas. I notice in your semi-annual statement you do make quite a lot of reference to the United States. It was only about three months ago that the United States Fed took the decision to make not one but two interest rate cuts in the period of a fortnight. Is that possible in Australia?

Mr Macfarlane—Anything is possible, but I would not regard that as being very likely. I think there are a number of things I can say in response to that. The first is that those two quick responses by the Fed almost certainly were a reaction to a fear that they were facing real financial market instability. They were facing a potential credit crunch, so those decisions were taken, one might almost say, in the heat of the moment. We are certainly not in that situation here. Our financial markets are extremely stable. So there really is not much of a parallel at all with the US at that time. The easing that we did was a very thoughtful, premeditated, precautionary step, as opposed to a reaction to some disturbing event that was occurring under our noses, which was the case for the US.

CHAIR—Yet in your semi-annual statement there was no indication that you were about to change our cash rate.

Mr Macfarlane—There is a good reason for that. You are in a position where you cannot say, 'We're thinking of doing this' or 'We're thinking of doing that.' You basically make a decision about what you are doing and you justify the decision you have taken. You cannot fly kites. I think that would be destabilising, particularly for the financial markets. I am not sure that it would be helpful for anyone else either.

CHAIR—Do you see our movements being more linked with what is happening in the United States and, to a lesser extent, other markets where we have seen a following of a trend that has been repeated again and again?

Mr Macfarlane—The answer to that is yes and no. I will start with the no part first. The thing that we did differently from comparable countries, you have to remember, was that we did not put interest rates up at any stage in 1997 or 1998, whereas all the countries that we normally compare ourselves to, including the United States, did put interest rates up. They put theirs up once in 1997. The Canadians, the New Zealanders and the Brits all went through a phase of putting rates up and then bringing them down. The fact is that over that three-year period we have not done that. We went down, had a long pause, looked at things and then we went down a little bit again. That suggests to me that the pattern of our interest rate movements is not tied in with the pattern of the US or anyone else in particular. That was the no part of my answer.

The yes part of my answer is that, if you take a very long-run view of the world, it is quite clear that, as inflation has been going down, as growth has been slowing, if you put a trend through interest rates, there has been a trend downward movement in international interest rates. Even though some of them went up and then came down again, the trend has been down. We have shared that trend, but we have not shared the month by month or quarter by quarter ups and downs.

CHAIR—I just want to tease out one more aspect of that. You referred to the United States economy as being more critical than it has been to our position in the future. How does that link us with any moves by the Fed?

Mr Macfarlane—It is true that the US economy has been very important. You can make an even broader statement. I think you could make the statement that over the last year we have probably spent more time looking at and worrying about the world economy than we have about our own economy. The developments in the world economy have been the things that have been the hardest to get a handle on and potentially the most dangerous and biggest sources of disturbances.

It is true that in the second half of this year we have looked very closely at (a) the US economy and (b) how we see the Fed as reading the US economy, to get some idea of how the world economy is developing. That is one of the reasons why we have been rather deliberative and, so many people might say, slow and thoughtful about making the decisions we have made—not because we were particularly worried about what was happening in our own economy but because we were trying to get a handle on what was happening in the world economy.

For a time, the biggest single threat to the world economy was this financial instability in the US. That seems to have passed. Looking ahead, the US is still very crucial. It is going through a period where it is slowing down. We are all hoping that it achieves this slowdown successfully—in popular parlance, that it has a soft landing. We are certainly spending a lot of time looking at the US, but that does not mean that we move our interest rates pari passu with the US.

Just to make that point a bit stronger, you will remember that from July 1997 until August 1998 we ran with our interest rates half a basis point lower than the US interest rates, which is the first time in my career that has happened. That signified to me the fact that we have room to move in a very different way from the US if circumstances are right.

Mr WILTON—Mr Macfarlane, you have indicated that the most recent easing was a thoughtful and premeditated act. Did you have any advance warning of the five per cent growth figure that was announced the same day? What if a thoughtful and premeditated act in easing is later seen to be a punt, given that the economy may not slow? In the event that the economy does not slow, what would be the impact of that easing on the balance of payments, inflation and interest rates?

Mr Macfarlane—I think the economy will slow. But, if it didn't—if we are completely wrong, if the rest of the world weakens and the Australian economy continues to grow at a very fast pace—you could imagine that you are back in a more normal world or an older world where, in those circumstances, there could be an inflationary threat. If there was an inflationary threat, monetary policy would be used accordingly. I do not foresee that as being likely, but that is always there. It is symmetrical. If growth goes too fast and prices pick up and wages pick up, there would be tightening. That was the case in 1994. I do not see a rerun of that. I think it is a most unlikely eventuality, but that is the textbook answer and we will stick to the textbook answer.

Mr WILTON—Did you have any advance warning of the five per cent rate?

Mr Macfarlane—No. Our own forecasts indicated to us that the September quarter figure was going to be a strongish one. That did not deter us from making the decision the previous day to ease, even though we knew that our easing would take place on the Wednesday and two hours later the national account figures would come out, and some people would say they made a mistake and that they should not have eased. The more thoughtful ones did not say that. They said the national account figures described something that had happened in the past, something that had happened between September 1997 and September 1998, and we were really making a decision for what was going to happen in 1999. **Mr WILTON**—I have one follow-up question. To pursue the Federal Reserve line, there is certainly a current perception in markets that the RBA would be more comfortable easing only following a US Federal Reserve decision to lower its federal funds target. I take it that the Reserve Bank sees risks for the Aussie dollar if the Australian cash rate were to fall below the federal funds rate. Overall, how important are decisions of the Federal Reserve in terms of RBA determinations on monetary policy?

Mr Macfarlane—If we went back, we would discover that the US made only one change in monetary policy in 1997. In March they raised the federal funds rate. In that same year, in May and then again in July, we lowered the cash rate. Clearly, their economy was in a different situation. It was growing too fast, and they had an inflationary threat. They put up their interest rates. We saw our economy in a different situation, and we put down our interest rates. Clearly, there was no similarity there at all.

When we come to this year, the Fed's behaviour was of great interest, particularly the two quick easings which indicated to us that they were worried about what was going to happen to the US economy. So that was a very important piece of news. We still did not do anything because the ground was changing so quickly.

If I can take you back to that period, it was a very volatile period. Between mid-August of this year and the first week of October, all sorts of things seemed to be happening. We had the Russian default. We had the huge increase in interest rates in emerging market debt and in all the lower credit quality debt, particularly in the US. We saw banks announcing these big third quarter losses. We saw the big hedge fund, Long-Term Capital Management, having to be rescued. Then, as I said, we saw the Fed do something which none of us really expected—these two quick easings of monetary policy. That was a very disturbed period, and it looked like there was a risk of a severe credit crunch, and that would obviously have very serious consequences for economic activity.

Then, almost as suddenly as it started, everything went quiet in the first week of October and the markets quietened down. But could we really rely on a piece of information, this little bit of quietness we saw from the first week in October to the first week in November, or was it worth waiting and having a longer look and seeing what was happening? We decided to wait and have a longer look. As we were having that longer look, it is true that the Fed did ease for the third time, as did a whole lot of other countries. It was quite clear that, even though the financial market instability had calmed down, the underlying trend was showing through that the world economy was one where inflation was coming down, commodity prices were coming down and interest rates were coming down. Not only did the Fed ease in that particular period; the Bank of England eased, Sweden eased twice, Denmark eased twice and a number of small European banks eased.

After our easing in December, the 11 countries of the European monetary system eased. It was an opportunity to sit back and try to detect the trend and separate the trend from this volatile disturbance that was occurring between August and October. The trend was not just that the Fed eased again but that the whole structure of world interest rates seemed to be edging down again.

Dr SOUTHCOTT—AlWhen the United States increased interest rates in the period from late 1996 to early 1997, I think they had some concerns with asset speculation which were not present in Australia.

Mr Macfarlane—Yes.

Dr SOUTHCOTT—If you look back at the 1980s, there was a period where we would see interest rates ratchet up very high and ratchet down very low. If we look at the 1990s, there has been much more stability in interest rates. I think you mentioned there could have been a case made six months ago for an easing in interest rates when the Australian dollar was under pressure. Certainly there was some pressure to increase interest rates. Do you think now we are seeing a feeling that it is much better to maintain stability of interest rates, to avoid any smoothing that interest rates might give you?

Mr Macfarlane—That is a difficult one to answer. I think it is a much better economic environment now than it was in the seventies or eighties because it is a lot less volatile. The biggest single difference from a macro-economic point of view is low inflation. It took a long time, but the interest rate structure adjusted to low inflation. That is why we have housing mortgages at six per cent. In the eighties at one stage they were 17 per cent. So the biggest single explanation is lower inflation and lower interest rates.

Once their average level is low, the evidence of the nineties is that they do not have to move very much. It would seem inconceivable that interest rates could ever have to move in either direction by the amounts that they moved in the 1980s. I think low inflation has also helped—but not guaranteed—to provide more stability in asset prices. In fact, in the nineties in Australia you could not write a story about asset prices. There would be very little to mention because they have been so stable. Of course, low inflation does not guarantee stable asset prices. We saw that in Japan in the 1980s, but it has certainly meant that asset prices have been relatively stable in Australia.

So we have not had to face this quandary which the US at times has had to face. We have not had to face it in the nineties where asset prices are doing one thing and the economy might be doing another thing. Monetary policy has to say which one is more important. All the textbooks tell you that it is what actual inflation or the real economy are doing that is important; that you should not worry about asset prices. But some of those textbooks might have to be rewritten as time goes by. Certainly we have seen in Japan that it was the asset prices where all the action was happening. We saw that in Scandinavia too. We saw in Australia in the late eighties to the early nineties that most of the action was in asset prices rather than in ordinary goods and services prices. But we do not have that quandary here. We are fortunate that we do not. The US is unfortunate that it does.

Dr SOUTHCOTT—Although we talk about the cash rate which has remained fairly stable for 18 months, the economy did receive some stimulus from lower interest rates for businesses and from the depreciation in the exchange rate.

Mr Macfarlane—Yes.

Dr SOUTHCOTT—Do you think as we look around the world we see arguments against Australia having a monetary conditions index?

Mr Macfarlane—I certainly see no case for having one. Mr Stevens, on my left, is a great authority on the subject and a very eloquent spokesperson for why they are not a good idea. If you want a detailed answer to that question, I can hand it over to him.

Dr SOUTHCOTT—I guess it is a fairly technical area, but some of the other English speaking countries raised interest rates in response to a depreciation. It does not seem to have had a great deal of effect except to have a big impact on the domestic economy.

Mr Macfarlane—The single biggest problem with this concept of a monetary conditions index, where you look at the exchange rate and the interest rates and you put them together to get a joint result, is that unless it is handled very sensibly whenever the exchange rate falls you interpret that as an easing of monetary policy. If you did not want to have an easing, you would put up interest rates. Sometimes a falling exchange rate is not, in a sense, an easing of monetary policy. It is an automatic easing in response to a contraction that is coming from overseas. If the exchange rate is going down because of an external event over which you have no control which forces your commodity prices down or reduces the demand for your exports, then an easing is exactly what you want and you should not resist it. That is a very superficial answer, but I think that is at the heart of the problem.

CHAIR—I would like to follow up on something raised by Dr Southcott. You said that things are a lot less volatile. Certainly on monetary policy that is true, but equally it might be said that in terms of that exchange rate, as you point out in the semi-annual statement, a US6c change over eight days in October was the largest appreciation in a similar period since the dollar was floated. Is there a risk that what you are stabilising in one area is translating into volatility in another area—namely, the exchange rate—and the downside effects that can have on some businesses?

Mr Macfarlane—I do not think that is the case. I think a more accurate statement is that the underlying factors in the economy that should explain the movements in the exchange rate have become much more stable, particularly inflation but even GDP growth, in the nineties than in the eighties. The exchange rate has not actually become more unstable in the nineties but it has not become much less unstable. In other words, everything else has become more stable. It has stayed at the same level of stability or instability. It is true that in terms of that particular rise that is the biggest rise, but we have had much bigger falls in the eighties than we have had in the nineties.

What I think you are really alluding to is the fact that foreign exchange rates move about much more than can be explained by underlying fundamentals—not just ours. In fact, ours has done pretty well. Ours has been reasonably stable. For example, the one that I quoted recently, the second biggest exchange rate in the world—the US dollar-yen—moved by 20 per cent in a month where nothing really happened to the US economy or the Japanese economy. There was no major turning point in any of the fundamentals in any of those economies, and it moved by 20 per cent in a month. That is a fact of the way the international system operates. Exchange rates are volatile.

CHAIR—We might come back to that whole question, including hedge funds, but I think two of my other committee members want to ask some questions on monetary policy.

Ms BURKE—I hate to labour the point, but I want to go back to the particular reasons that you determined on 2 December to drop the rate, given the months of speculation and knowing that two hours later there would be an announcement that you had probably predicted better than most analysts around you that is was going to be stronger than it was. Given the months of speculation, why 2 December?

Mr Macfarlane—I think my main explanation is that we wanted some time to think to try to distil the trend from the volatility in the international marketplace. That is the main explanation. The other explanation is that the cost of waiting was nil. It was not as though there was an urgency about it. It was not as though we had a financial crisis on our hands or the economy was collapsing under us. The cost of waiting for some more information was virtually nil. In those circumstances I think it is worth while waiting for some more information.

I might also make a general point that in the effect of monetary policy on the economy it does not matter whether you do a quarter point change this month or next month. There is no way you could tell whether it had any difference in impact because it was done one month or another month. For the economy, it really does not make much difference. For people in financial markets, particularly economists who are employed by big banks, they think it is a life or death matter—whether interest rates move today, next week or in a month's time—because, if you have a big portfolio in the money market, the bond market or the foreign exchange market and you can pick a change a little bit faster than the average of your competitors, you make some money. For them it is a life or death matter. For the economy as a whole it is not a life or death matter at all. I think the nature of the press is that the views of those people who think it is a life or death matter are the ones that get reflected.

Mr LATHAM—Mr Macfarlane, you mentioned in your opening statement the benefits of inflation, but you also said that the Australian economy is yet to fully adjust to the low inflationary environment. Does that mean the bank regards inflationary expectations in Australia as still too high and, if so, by how much? Further, what do you think needs to be done to complete the adjustment to the low inflation environment?

Mr Macfarlane—The answer to the first one is that I think consumer price expectations, as indicated by the Melbourne Institute survey, have them at 3½ and sometimes four instead of 2½. So, yes, they are a good percentage point higher than we would judge the likely outcome for inflation to be. We do not pay a huge cost for this. They are not huge distortions, but my feeling is that when the adjustment fully takes place we will find people borrowing for houses fixed term over 20 years. We will find the Australian government issuing 30-year bonds, as they do in the US, rather than 10- to 12-year bonds. I think the adjustment has not completely taken place.

The second question was what do we do about it. I do not think there is really anything much to do about it now. There was a lot of proselytising that I and a lot of other people went on with in the first half of the nineties, but I think the adjustment will eventually take place as people see and gradually absorb the fact that inflation is very low and is likely to stay low. I think the area where it matters probably more than anything else has been wage bargaining. It is amazing the extent at the present time to which the adjustment has occurred there.

Dr SOUTHCOTT—On that issue, in terms of inflationary expectations, what do you anticipate the CPI to be in July 2000? What do you expect it to be after the impact of a GST? Do you think there is any danger that that 1.9 per cent increase could become embedded in inflationary expectations with wage negotiations and so on?

Mr Macfarlane—My understanding of the history of countries that have introduced a GST is that in the vast majority of cases there has been a once-off lift in prices, as the new post-tax prices are marked in, and that has not fed on to a higher general rate of inflation. Remember that most of these GSTs were introduced in higher inflationary periods where that was more likely to occur. The ones that have been introduced most recently have been New Zealand, Canada and Japan, which were all introduced post the mid-eighties. In my reading of those three cases, it was a once-off lift in the price level, and it did not get built into the underlying inflation.

Although that has not always been the case, that has mainly been the case, and it certainly has been the case in the most recent examples. That is also true of those countries which already had a GST and raised it—basically, the price level goes up by the amount of the GST or the increase in the GST. So that is the assumption that we would be working on.

Dr SOUTHCOTT—In view of that fact, in that period for the 12 months after the introduction when you would anticipate there would be a blip, will you be looking at the underlying inflation and using that for your two to three per cent?

Mr Macfarlane—With that once-off increase in the price level that results from the change to the tax system, it does not try to resist that.

Mr LATHAM—In the semi-annual statement, a lot of emphasis is given to steadiness in monetary policy settings. What does ‘steadiness’ mean in the practical application of monetary policy? Is it a reflection on how many times you move rates, or the perception you are trying to build in the market that you are not easily panicked by movements in the exchange rate, or external factors that might impact on policy settings here?

Mr Macfarlane—I think the two things you have said are related. I think it is important that we do not do knee-jerk reactions, and it is important that the market understands that we do not do that. If you do not do those, it is likely over a period of years that you will not actually make as many movements as some countries that do things more quickly.

There are some people who have the opposite point of view and who think that, if a little bit of data changes or something, you should make an adjustment and, if it changes the other way the next week, you go down again, and you should be constantly moving like that. I do not think that is the way to do it. I think the way we do it, which is a more deliberative way, is a better way of doing it. But I cannot prove that is a better way of doing it.

Mr LATHAM—Does it signify any downgrading of the bank's ambitions for finetuning the macro economy?

Mr Macfarlane—I do not think we ever really claimed we could finetune it; I do not. The forecast I am giving you indicates that we do not think we can finetune it. We think that, if you have a big enough external contraction that runs long enough, you yourself eventually cop some of that in terms of lower growth. You cannot choose a desired path for growth and adjust the instruments and constantly be on that. What you are trying to do is maximise the length of the expansion rather than trying to keep to some target annual growth rate.

Mr LATHAM—At page 34 of the semi-annual statement, talking about the impact of the world economic slowdown on Australia, it is stated that 'the resilience of the economy to date suggests that it is global growth rather than growth in trading partners which is of most importance'. Is this something that has caught the bank by surprise? What are you driving at with that statement? What are the mechanisms that lead to that conclusion?

Mr Macfarlane—What we are driving at is, when the Asian crisis first developed or was emerging, there was a widespread view that Australia was really going to cop it because so many of our exports go to Asia. This was bolstered by people doing what I would regard as no more than back-of-the-envelope calculations, where they looked around our export markets and saw Thai imports going down by 30 per cent, Korean imports going down by 35 per cent and Indonesian imports going down by such-and-such. People added these together and said, 'Therefore, our markets are going down by'—let us say—'20 per cent; Australian exports will go down by 20 per cent.' That is because they did not realise that it was really global growth that mattered rather than regional growth because the nature of a lot of our exports is that, if you cannot sell your zinc or your copper to Korea, you just sell it wherever the demand is. It might be in the US; it might be in Europe; it might be in India; it might be anywhere.

So the thing that determined our export performance was really global growth rather than the growth in our region. In other words, because of the nature of our exports, we were in much better shape to handle the regional contraction than if we had had a different export mix. That is a very shorthand way of trying to point out that people who did that—and maybe we did too for a month or two; as soon as the Asian crisis emerged we calculated what we thought was going to happen in this crude, sort of fixed co-efficient input-output view of the world—got the wrong answer. That is what I was trying to say.

Mr LATHAM—So you were learning by experience after a couple of months of those particular calculations?

Mr Macfarlane—I certainly saw these sorts of calculations appearing in the press. I cannot even remember—do you remember, Glenn?—whether we actually did any.

Mr Stevens—Sure we did. But I think we were saying early on that there will be a diversion of some of the exports to other places. I think we might have been seen by some as being a bit optimistic in saying that, but certainly for the resources that has definitely been true. That is not that big a surprise; that is the nature of these commodities.

There has been a presumption amongst a lot of forecasters that the right way to think about the world is a kind of: do our trading partner group, figure out their GDP growth and work out our export forecasts that way. That has not given you that big a difference anyway, comparing that with what the world did most of the time. The growth rates of our trading partners have tended to be higher on average but the cycles up and down were not that different. They are very different this time. Our view early on was that there will be diversion to the parts of the world that are still growing. I think that has basically turned out to be correct. So it has been quite a nice experiment, in a way, for economists to get a handle on whether it is the trading partner group that is really important or the globe.

Mr LATHAM—So you have been much less worried about the current account deficit than those economists who look at the trading partners? Would you continue to take that attitude?

Mr Macfarlane—I think no-one looks at the trading partners thing now. I think everyone has realised that the biggest effect through to us is: Asia slows down, Asia is part of the world, therefore the world slows down and, even though we divert them to other markets, the price of the commodities falls. So what we get is a sort of terms of trade shock. The effect on us goes through commodity prices rather than just unsold stocks of stuff that we have produced. I think everyone has accepted that now. So I do not think there are really two schools of thought any more—those who think it is a regional thing and those who think it is global. Everyone pretty well accepts that it is global.

Mr LATHAM—Just one other question about the business cycle and other countries: it has always been assumed that Australia is closely correlated to the US economy in the business cycle. Is that a conclusion that the bank still holds? If so, what is your thinking, given your earlier comments about the uncertainty in the US and the inevitability of a slowdown? Do you see Australia having the tight correlation with the US business cycle that we have had in the past?

Mr Macfarlane—You are probably aware that the correlation between the Australian business cycle and the US one is so close that it is uncanny. In fact, it defies commonsense it is so close. That is in the past. We keep thinking that the two economies might go in different directions, but they have not over the last couple of years. Again, the correlation has been very strong.

That is one of the reasons why we are very interested in what is happening to the US economy. That is why we have a very strong vested interest in the US having a soft landing. That still is our mainstream forecast—that they will have a soft landing. For a time in that period I referred to, from August to October, there did seem to be a risk that they were going to have a hard one, which is what you would get if a systemic financial event occurred at the same time. But at the moment we are assuming that the most likely outcome is that they will have a soft landing.

Mr LATHAM—What are the downside risks, though, in the US? Some people speculate about a property bust, for instance.

Mr Macfarlane—The more common speculation I have heard is about the share market, now that the Dow is so high. It is so high that 2½ years ago, or whatever it was, Chairman Greenspan was subtly telling everyone that he thought it was too high. It was so high in the first half of 1997 that they tightened monetary policy, partly to put a shot across the bows. Now it is much higher. I think that is why people worry that companies will not be able to achieve the earnings that are implied by the prices that their shares command; that somehow or other some event will trigger a realisation and then, like all asset markets, it will move a long way.

CHAIR—Is that a forecast?

Mr Macfarlane—I got into trouble doing that once before. It is hard enough forecasting the things that I know something about without trying to forecast the Dow. If my job had been forecasting it for the last three years, I would have lost my job three times, so I do not think I will try to do it.

CHAIR—Mr Macfarlane, in your opening remarks—I think you called it your interim report—you talked about the various factors of why you feel we had done better than some had expected. You talked, in particular, about the perception of the soundness of economic policies and so on. Would it be reasonable to assume that included in that is the expectation of tax reform? What effect do you think tax reform is likely to have on our economy?

Mr Macfarlane—I do not know that I know how to answer that one; it is a rather difficult one. I know a bit about the aspects of tax reform that concern the Reserve Bank's performance of its job. In fact, we discussed that when I was answering the question from Dr Southcott. As I say, the indications are that there should not be a macro-economic or certainly an inflation problem coming from that. As to the public's perceptions, I do not know that I can really answer. A lot of people strongly approve, and presumably there is another group of people who are apprehensive. I do not know what the net balance is.

CHAIR—My question really is: what effect do you think tax reform is going to have on the performance of the economy?

Mr Macfarlane—In the long run I think it has to have a good effect. We got ourselves into a situation where we have too narrow a tax base. That is the situation we are in now; we have too narrow a tax base. The marginal tax rates on people close to average weekly earnings are extremely high by international standards, and it must have disincentive effects. So I think in the long run a tax reform to reduce that distortion has to be beneficial.

Dr SOUTHCOTT—Mr Macfarlane, we have already said that the forecast for growth is going to be down a bit over the next year but, if we continue to see an economy with strong growth and low inflation but a deflationary world environment in which Australian firms would not be able to pass on price increases, what would be the bank's view? Would that be a scenario in which you would consider continuing to cut interest rates? What would be the risks of that?

Mr Macfarlane—I am not sure that I fully understand the scenario. Is it a scenario of strong growth but low inflation?

Dr SOUTHCOTT—Strong domestic growth with low inflation and a deflationary world environment.

Mr Macfarlane—If you had that world, that would be an argument for lower interest rates. If you had low inflation here and deflationary influences in the world economy, that would be an argument for lower interest rates.

Mr WILTON—Mr Macfarlane, just getting back to tax and the tax package, compensation measures flowing from a GST are predicated on 100 per cent pass-through of business savings to the consumer. Given that, for example, the banking sector—banks as businesses—is notoriously slow to pass on cuts to official rates, what is the likelihood of a 100 per cent pass-through of savings following the abolition of taxes like FID and BAD in the banking sector?

Mr Macfarlane—I do not know the exact answer to that. My feeling is that they would be passed on, but you are asking: what is the timetable for the pass—

Mr WILTON—Is it your view that they be passed on in full, which is what the package is predicated on?

Mr Macfarlane—I think you would have to assume they would be passed on in full. That is a reasonable assumption on which to base any changes in taxes, but I do not know the timing. It could well be that, with some of these things, competition takes a little bit longer to winkle out the pass-through than is assumed. But you have to work on the assumption that they are passed through; that people do not take the opportunity for a once-and-for-all windfall gain; that competition makes sure that that does not happen.

Mr WILTON—On the same broad area, has the bank done its own modelling on the validity of the government's 1.9 per cent inflationary impact following the introduction of any GST?

Mr Macfarlane—No, we have not, and we probably will not be doing anything like that until we know the exact shape of the package.

Proceedings suspended from 11.42 a.m. to 11.50 a.m.

CHAIR—There are quite a few other issues that the committee would like to pursue. I might open up now looking at some of the domestic issues with interest rates and the interposing of bank fees and the fact that interest rates are coming down but bank fees seem to be responding the other way. Has the bank done any work to look at the net effect of the fact that we have seen quite a lot of competitive pressure in the interest rate field, particularly in housing lending and, more recently, in small business lending, vis-a-vis the increase in fees and charges?

Mr Macfarlane—This is actually a very difficult subject.

CHAIR—It is difficult for us too.

Mr Macfarlane—It is much easier to do the work on the margins, which we have done a lot of, as you know, and we publish it regularly. The work on fees and charges is so difficult that I am going to hand this difficult question to Dr Grenville to see whether he can be more concrete than I could be.

Dr Grenville—On fees first, there is certainly a strong perception that fees are going up, and there is no doubt the banks have in their minds a rejigging of their income earning streams. As competition has cut into their margins, they have tried to price things in more economic terms. Obviously the perception is right, but one thing the perception misses out on is the possibility that, as banks reprice various products, the consumers themselves are shifting their usage of those products, if they are properly priced, towards more efficient products—products which can provide the same service but at a smaller cost, and the principal change there is electronic as opposed to paper based systems.

It is a very long way of getting to the bottom line, which is that, even though fees have gone up in absolute terms, they have not risen nearly as much as that perception would imply as a percentage of the balance sheets of the banks. So, if you were judging the two things and trying to weigh them against each other—we have not done a formal calculation of that, but let me just hazard a guess—the cut in margins, which has been very significant over the last few years during the 1990s, would outweigh the rise in fees, particularly taking into account the fact that many people have the ability to shift from one product to another.

CHAIR—You say you have not actually done any formal work. Have you done any sort of exploratory work?

Dr Grenville—Not to weigh the two things formally against each other, no.

Mr Macfarlane—Our observation when we did our international comparisons work—this is before the housing margins came down—was that margins in Australia were higher than comparable banks in comparable countries but fees were lower. That is, Australian banks at that time, which was about three years ago, had generally lower fees than the UK and US banks.

Dr Grenville—They are not only lower but also a smaller proportion of total income in Australia than in the obvious international comparisons that we can do with the UK, the US and Canada.

Ms BURKE—Given all those things you have just pointed out—margin squeeze, the cherry pickers coming along and trying to get interest rates down, and, I would coin it, the forced migration of people onto lower income streams through the banking mechanism and something the banks have actually done by introducing fees and charges as opposed to just having to recoup their margin squeeze—and that is a debate you can have out there; I am not asking you to comment; I am just predicating my question—would the Reserve Bank please provide the committee with the detailed history of changes in bank fees and charges in the last 20 years so we could have some sort of comparison going forward?

Mr Macfarlane—We will do what we can. We have already got a request from our small business panel who feel as though they have been complaining about margins to small business lending, and that has come down quite a lot. Now the particular fees that worry them are the fees associated with the borrowing establishment charges and what have you rather than transaction fees. So we are already doing some work on that class of fees. We will see what we can do on transaction fees. If it was easy, we would have done it.

Ms BURKE—There are two factors we have both been talking about. There are the international comparisons, which I think you rightly point out are difficult because Australia had a greater rate of cross-subsidisation than its international partners, and that has been a history of the banking system we have in our country versus anything else. Also, just looking at the progress of the fees and charges over time, it has become more of an issue in the press—it has been there for a while; people just did not realise it. They are the two things I would like to look at.

I would like to go back to something that Greg mentioned earlier about banks generally being slower to pass on interest rate cuts. Does the Reserve Bank have any evidence of this? If it does—I suppose I am pre-empting your answer—does that indicate that there is less than adequate competition in the area?

Mr Macfarlane—There certainly was a period when we were drawing attention to the fact that the lag for the reductions was longer than the lag for the rises. We think that is changing now. For example, in this most recent one, it was about the same lag as when rates were going up. There was a period when we used to draw attention to that, but I think that has changed, just like these margins. Competition does actually finally get you there. You have some numbers there, haven't you?

Dr Grenville—We have detailed numbers. One problem in calculating this is that the banks argue the critical thing for them is their cost of funds and the changes in that do not exactly correspond with our changes in the cash rate. So, whenever we try to write about this issue, we have arguments with them about when exactly is the critical moment we should start the clock running when we are trying to estimate lags. We are always putting these things forward in a very tentative way. Let me give you some tentative figures. Compared with 1996-97, the lag now looks like it is about half the length. For housing, it is half the length. For small business, it has shortened dramatically. It is very quick. There are very short lags for small business and similarly for large business.

Mr Macfarlane—It has shortened from 35 days to nine.

Ms BURKE—So you would see then that there is greater competition in respect of small business?

Mr Macfarlane—Yes.

Dr SOUTHCOTT—In terms of competition between the banks if there was any merger of the four large banks in Australia, do you think there would be a lessening of competition? Also, from the Reserve Bank's point of view, if the domestic banking sector became more concentrated, would there be any moral hazard involved in that—that banks could be so big that they could not possibly fail?

Mr Macfarlane—I think your first question is trying to get me to make a comment about the four-pillars policy. I tried to avoid that question recently and accidentally seem to have made a comment about it. I will try to do a better job this time of avoiding the question. There are two issues at stake, and in neither of them is the Reserve Bank involved. There is a prudential issue, which is for APRA to give an opinion if that is asked for, and there is a competition policy issue, which is for the ACCC to give an opinion. I have no responsibilities in that area at all.

All I tried to say, which I will say again, was that banking is just like any other industry. There is a body of law that applies to competition policy and there is an institution whose job it is to interpret that body of law. If the banks were able to convince that body that there would be wide benefits for the community, I am sure that institution, the ACCC, would agree. But it is a matter for competition policy, and I do not claim to be an authority on that.

Mr WILTON—The bank's 1996 submission to the Wallis inquiry stated, 'It would be a much more serious step, however, to redefine competition policy in a way which effectively reduced the number of major banks in Australia to two.' Is that still the bank's view?

Mr Macfarlane—If the only choice was four or two—which is what the pundits say—then a system of two, I think, would be the most concentrated banking system of a major country. I would probably prefer that someone else try that experiment, rather than have Australia be the one to try it.

Mr WILTON—You would be aware that the Canadian finance minister this morning announced that they would oppose similar merger arrangements in Canada.

Mr Macfarlane—Yes, I am aware of that.

Ms BURKE—One of the areas that the Reserve Bank does have legitimacy over in this area is employment, given its monetary policy implications. There have been 23,000 retrenchments from the industry in the last three years alone, 38,819 full-time jobs gone in the last eight years, 1,306 branches closed in the last eight years and 506 branches closed in the last year. These figures are drawn from ABS statistics and from your own statistics, so I am probably not telling you anything you do not know. From personal experience, I would probably contest that some of the retrenchment numbers are actually higher. Given the implications of the merger on employment and unemployment in the two banks, what would the Reserve Bank's position be, since that is one of the areas you actually cover?

Mr Macfarlane—We do not have responsibility for employment in any particular industry.

Ms BURKE—No, but I suppose I am getting at the effect of employment on monetary policy.

Mr Macfarlane—We cannot really tell. We do not have the responsibility to tell any industry, 'You have got too few people,' or 'You have got too many.' We rely on competition to bring about results there. Of course, banking is not the only industry where there has been a contraction in numbers. In a lot of industries where there are a lot of uncomplicated clerical functions, the staff numbers have gone down. In fact, our own staff numbers have gone down much faster than those in the commercial banks.

Ms BURKE—But, if there is a merger, if the four pillars fall over and four become two, 40,000 jobs will go. It is a bigger loss of jobs than you would see in any other industry at one time.

Mr Macfarlane—It could be. I do not know the answer.

Mr LATHAM—Mr Macfarlane, I want to raise a few issues from your fascinating Shann Memorial Lecture, which unfortunately did not get the coverage—

CHAIR—Before you do that, there is one question I wanted to ask to finish up this issue. With the competition in interest rates and small business lending, which we were talking about before, one area that does not seem to have felt the same competition is credit cards. In fact, I think the rates in the last two years have gone from 16.2 per cent down to about 15.1 per cent, which certainly is not anything like what we have seen in other areas. What steps does the bank think should be taken to try to see competition work in that area?

Mr Macfarlane—I do not know the answer to that one, I am sorry. I have never really understood why. Everywhere in the world it is the same; the interest rates on credit cards are so high. I can only assume there is a very high default and delinquency history. But I do not know the answer. I really do not know. I think you might do better to ask that question to APRA, but even they may well say it is not really their area of expertise. Do you ever speak to the ACCC?

CHAIR—Yes.

Mr Macfarlane—I think you would be most likely to get an informed answer from them. I do not know. Like you, I have always been surprised that they always seem to be so high.

CHAIR—So the Reserve Bank does not propose to do any work on that?

Mr Macfarlane—No. We do not have any responsibility for the banking sector per se. We have responsibility for monetary policy and financial systems stability—big issues that cover all financial sectors. But we do not collect data from banks. We do not have the power to ask for data from banks, because we do not have the relationship with the banking industry that we used to have.

Mr LATHAM—On the history of monetary policy that you set out in the Shann Memorial Lecture, I was surprised by two things. The first was the bank's sensitivity to political controversies. It was fairly clear that the bank kept its powder dry on some important issues in the early nineties because of the worry about political controversy. Is that a worry that the bank still holds, or do you think that most of the major issues about monetary policy have been worked out in the political arena? The second was your conclusion that:

Economic historians who look back over the past quarter of a century may well be surprised by the huge role played by inflation in shaping our attitudes to monetary policy.

Do you think the historians will be surprised because the bank kept on saying that it did not really give any greater emphasis to price stability than it did the employment objective in the legislation covering the bank? Is there a paradox here that you are using the historical context to spell out subtle changes that the bank had made in its priorities through the course of the nineties, inflation versus employment—at the time a bit worried about political controversy if you actually came out and said that, but now, with the coast clear, you are putting it down in a lecture about history?

Mr Macfarlane—One of the things I wanted to bring out there—and no-one was at fault—was that we in Australia were a bit unfortunate that, when the issue of inflation targeting and central bank independence became seen internationally as a promising basis for monetary policy, before we could say very much at all about the subject and before we could engage in debate and discussion with other people, it immediately became polarised in the political arena with the then government seeing no virtue in it at all and the then opposition regarding it as the panacea which would fix monetary policy in a stroke.

That was a very difficult environment for us to work in because anything we said would have been immediately politicised. The beauty of the situation is, as time has evolved, there is no such polarisation any more. There is a remarkable degree of bilateral support for the sorts of arrangements that we have, which puts us in a much better position of being able to be completely open about what we think on these issues. In that period, from about 1989 to 1993 particularly, I cannot conceive of anything that we could have said which would not have become highly politically controversial. It would have set back the cause rather than advanced it.

Mr LATHAM—So that is a constraint which we no longer have. Is that the reason why, in this historical context, you have pointed out that the bank through the nineties has upgraded the priority it gives to price stability versus the employment objectives in the act?

Mr Macfarlane—It explains why we did not actually formally introduce the inflation target—we did not even informally introduce it until 1993—even though we were working with a model internally that had a lot of the same characteristics. So, in a sense, what I was doing was explaining the delay there. During that period we came in for heaps of criticism, a massive amount of criticism, for not knowing what our model was, for not being specific about what we were doing and, particularly, for being too tolerant of high inflation.

We do not come in for that criticism now. Just as it is no longer politically sensitive to talk about inflation targeting and central bank independence, with nearly a decade of low inflation behind us, Australia is no longer regarded as being an inflation-prone country and its central bank is no longer regarded as being soft on inflation. That lecture was more one on history rather than one on economics. It was just a way of getting down that particular period before everyone had forgotten it.

Mr LATHAM—But, for some of us who sat through public hearings with your predecessor, it was very interesting history. Further to that point, with those political threads or issues now resolved or cleared, is the bank now happy with the level of transparency and the public understanding of its policy attitudes and framework?

Mr Macfarlane—Yes, I am quite happy with that. Of course there has been enormous advance on what it used to be. There will no doubt always be people asking for more, particularly the people who are very worried about whether monetary policy is going to change today or in a week’s time. The more information the better. It is all grist to the mill. But whether it actually would be helpful, whether it actually would give people a clear understanding of what was going on, I do not know.

But I think we pass the transparency tests. The crucial thing is we are not operating a secret model that is different from the one we profess. Everyone knows what the model is, even though it is not as deterministic as they would like. People would like it to be so mechanical that you could predict with accuracy exactly what day monetary policy is going to be tightened or eased. It is never going to be that mechanical. But I think everyone understands the model, and they know that we do follow it.

We actually have a few feathers in our cap on transparency, one of which was the practice when we changed policy of making a big and quite detailed announcement that we had and exactly why we did it. It may surprise you that it was ever otherwise, but it was. In fact, the standard central banking model was that you simply operated in the money market and, if you wanted higher interest rates, you just took some cash out. The interest rates would nudge up and you would just rely on the market to get the message that things were now tighter. That is the way the US operated, in fact, until about three years ago. That is the way we operated too, until 1990.

We thought it was a pretty good system. In fact, we now know that the present system is much better, but that was the standard way of doing it. My predecessor was the one who said, ‘No, let’s not do it that way. Let’s put out an announcement. Let’s not run the risk of it being misunderstood. Let’s say exactly what day it is that we changed, exactly what the rate was, what the new rate would be and the reasons we did it.’ In that particular dimension of transparency, we were a long way ahead of other major central banks at that time—like the Americans and the Canadians. But in other areas we were behind, as you were alluding. We really gave everyone the impression that we did not know what model we were using.

Mr LATHAM—Just one piece of historical information that might be useful: who initiated the 1996 statement on the conduct of monetary policy?

Mr Macfarlane—The government. On the bits that were up to us, we already had an inflation target and we had an act which gave us a high degree of independence. It was the job of the government to formally support the target and to recognise the independence that was contained in the act. It was up to the government to do that.

Mr LATHAM—Finally, do you think you have a problem with announcement effects now? Is their impact diminished by the small size of adjustments in a low interest rate environment? One-quarter of a percentage point does not seem to give you the announcement bang that you might have got in a different environment.

Mr Macfarlane—Yes, you are right in one sense. If you had a bigger move, it would have a bigger impact. A 50-basis point move would have a bigger impact than a 25-basis point move. But, in the situation we are in, we are not really looking for a big announcement effect and a big immediate impact. That monetary policy easing is essentially a precautionary and pre-emptive one. It has some similarities to what the Fed used to phrase as 'taking out a bit of insurance'. It was not something that was meant to cause people to go rushing back to their screens and to deal frantically. It was meant to be in the groove, forward looking, precautionary.

CHAIR—We might move on to questions on some international issues. Firstly, the Reserve Bank is involved with a number of organisations, including the IMF, the OECD, the Bank for International Settlements, the East Asia and Pacific group, APEC and so on. How effective do you feel those organisations have been in addressing some of the financial problems that have been encountered in the current climate in the Asian region?

Mr Macfarlane—I do not suppose we can say they have been terrifically effective in that the contractions in the Asian region turned out to be much more severe than people thought and the contagion spread more widely than people thought. You listed a whole range of institutions. I think that is, in some sense, part of the problem in that there are just so many. Some of them are very specific and they are not meant to be dealing with major economic crises. The institutions have been coming to grips with a new type of economic crisis and they have been learning, but I would have thought that the last 18 months has not been a period where there has been a great achievement for international economic cooperation.

CHAIR—Are you increasing your emphasis on input to these organisations?

Mr Macfarlane—Yes, we have quite a lot. We at this institution had a relatively minor involvement until the Asian crisis. I think the Asian crisis was the thing that galvanised us into action where we realised that the future of our own economy depended, in some sense, almost more on what happened outside it than what was happening inside it. The things inside were running pretty smoothly and the disturbances were all coming from outside. So we formed particular views which we have expressed reasonably forcefully.

CHAIR—Do you feel that the Bank of Japan should be playing a bigger role than it has?

Mr Macfarlane—The Japanese institutions are in a rather embattled position at the moment. I think it is rather difficult for them to play a leadership role, particularly given their own unpopularity within their own country. The difficulties that the Japanese economy is experiencing mean that they are not in a strong position to start lecturing anyone. Of course the country which is in the very strong position is the United States, which you always look to for the leadership role in these issues.

Dr SOUTHCOTT—After the breakdown of the Bretton Woods agreement, we have not normally talked about capital controls. I am interested to hear your comments that capital controls could be considered for emerging economies. The speech which set it out very well was the one at the CEDA annual dinner. Do you think the capital controls should be imposed by the countries themselves, as it was with Bretton Woods? How would you envision it working?

Mr Macfarlane—Our main point—this is not just mine; Dr Grenville has the same views and, in fact, in many of these areas he is much more knowledgeable than I am—is that we think the international pressure to dismantle the remaining, in many cases, quite minor impediments to the free movement of international capital was a mistake. I think some of these countries were pushed into getting rid of these things far too early. They had very small and very fragile domestic financial systems. They were subject to massive movements in and out of international capital.

Our view is that this purist approach was wrong. Whilst we are generally obviously in favour of open international goods markets and open international capital markets, you do not have to go straight to perfection in such a short time. Countries which adopted a little more pragmatic an approach have done better. The first example is Chile, which was being inundated with capital and which imposed a tax that had the effect of falling quite heavily on very short-term capital. Even the much vaunted Singapore financial markets have restrictions, particularly restrictions on Singaporean banks lending Singapore dollars to non-residents. So there are relatively minor things that can cut off some of the extreme excesses. We thought we should not have been going around preaching to these countries, ‘You have to get rid of this.’

We would have said, ‘Ultimately, you probably will. You’re never going to have really first-world living standards until you have pretty open goods and capital markets.’ But there is a transition phase of how you get there. If you try to do it all in a rush, you can have such destabilisation that the benefits of the capital inflow are outweighed by the instability that results. There certainly are always benefits, but they can be outweighed by the instability.

Dr SOUTHCOTT—Yesterday someone told me that Chile were dispensing with their controls for short-term capital.

Mr Macfarlane—They have reduced the tax rate to zero because they do not have the problem of excessive capital inflow at the moment. None of the emerging markets have that problem at the moment. But, if they become flavour of the month again, my assumption is that they will probably put that tax rate back to where it was. They have not dismantled the system; they have put the rate down to zero. But all the legislation is still there.

Mr LATHAM—What was the source of the international pressure that you mentioned? What is the Western policy establishment?

Mr Macfarlane—The pressure was mainly from the US and the IMF. The Western policy establishment is a shorthand for that conventional view that you go to free markets immediately. The most obvious proponents were the IMF, the US Treasury and also a number of other major developed countries.

Mr LATHAM—Is Australia now putting a different view within the IMF about this?

Mr Macfarlane—The Australian view is as contained in the Prime Minister’s recent statement, which says much the same sorts of things I have been saying. The penalty of a policy error is now far greater than the policy shortcoming so that we have to do some of these things—which I am sure you are going to ask about—to do with hedge funds, to do with private sector burden sharing and all that sort of stuff. That is a sort of revisionism. None of that stuff was contemplated by the conventional view two years ago.

Mr LATHAM—Have you got the Treasury in the revisionist camp?

Mr Macfarlane—Yes, indeed.

CHAIR—On this matter, you are on the Prime Minister’s task force on international financial reform. Is that going to report before Christmas?

Mr Macfarlane—I believe it is. There is a report. I believe it is reporting before, but I am not sure on that. I think it is. I have seen a draft floating around, so I think it is going to report before Christmas.

Dr SOUTHCOTT—With regard to the hedge funds, you have said that they now have the capacity to have almost infinite leverage. Are there any proposals to review the capital adequacy requirements for banks? Also internationally, do you think there are any proposals to look at the Basel capital rules with a view to identifying which banks are actually lending to the hedge funds?

Mr Macfarlane—There is certainly widespread support for bringing hedge funds—sometimes people do not call them hedge funds because it is a very funny word. Usually they are the opposite of a hedge.

CHAIR—You use ‘haircuts’ in your statement.

Mr Macfarlane—Yes. There is certainly widespread support for bringing hedge funds into the disclosure net at least, possibly the supervision net. There is widespread support for that. So the first thing is to find out at least how big they are, what their balance sheet is and probably what their off-balance sheet exposures are in aggregate, not individual positions. I do not think anyone is asking for that. The second thing is for the banks to review their relationship with hedge funds, which has become quite incestuous. It was clear that banks were so keen to get the business of hedge funds that they were pretty careless about some of the prudential standards that they were applying. They were not asking questions that they should have been asking. It is also clear that, in some financial instruments, there is no discipline or no margin—the shorthand term is haircut—that would tie down the size of the position that the non-regulated entity, the hedge fund, could take. Then, in some types of transactions, almost infinite leverage becomes possible.

I think there is a view that that is clearly a very dangerous situation and that banks are going to have to do a much better job of credit assessment. In fact, maybe some of the favourable aspects of the Basel capital requirements, which in fact make it very easy for banks to extend positions to other financial institutions, might be in need of review. They might actually have to be required to have a little more capital than they are currently backing these positions with. So there are a whole range of these issues which people are looking at.

The Group of 22 put out a report which recommended that a group be set up to look into these issues. The Bank of International Settlements has just established such a group. We will have someone on that group. So progress is occurring. But it is amazing that it has taken so long and that there should be such a group of institutions which can have such a big influence on particular markets outside the US mainly, because the US market is just too big. They cannot have much of an influence there, but they can have a very big influence on markets outside the US, and all we know about them is hearsay.

CHAIR—Don't you find that rather disturbing? You have this group accumulating large amounts of capital and betting on currencies and undermining currencies.

Mr Macfarlane—The technical reason is that they are a type of mutual fund but with a very small number of participants. That is how they started. You founded a hedge fund and you went around and got 25 rich individuals who put some money in and then you went and made your investments. So the lack of disclosure or supervision is based on the grounds that these are very rich people and there are only a small number. You do not have to protect them prudentially from a failure because who cares whether a hedge fund fails. So that is why, historically, there has been no supervision or disclosure.

But that is obviously not the case now because they have become very large and very intertwined with the major investment banks and commercial banks. We even saw one of them become so big that the US Fed had to organise a rescue which they very clearly said in their press release was because it would have systemic implications for the US and international economy. So once something is as big as that and can have those sorts of threats to the world economy, clearly you can no longer just treat it as being some small peripheral player.

CHAIR—Do you feel this is systematic of something that is developing that may, in the short to medium term, be rather unhealthy? For example, my understanding of the Australian dollar right now is that it is traded at something like 100 times the actual trade of Australia. There seems to be a very high emphasis on this speculation rather than real production.

Mr Macfarlane—The fact that there is a heavy turnover in the Australian dollar and in other currencies does not particularly disturb me because there has always been a very heavy turnover. It is like the insurance industry or even the bookmaking industry. If I go to you and I want to sell you $A100 million or $US100 million, that is just too big an exposure for you to accept. So the moment you get it you immediately lay it off with 10 other people. If it is too big for some of them, they will lay it off with people also. So you get this layering that goes on.

That is the main explanation for why the turnover in the foreign exchange market is so high. It is clearly higher than exports or imports because there are also all the capital transactions occurring. For example, someone is taking over a company or someone is lending someone some money. In addition, there is all this laying of bets. The fact that the turnover in the foreign exchange market is so high relative to underlying transactions does not particularly disturb me.

CHAIR—What about the banks making proper provision for their liabilities as clearing houses for the Sydney Futures Exchange? Are you happy that they have made proper provision?

Mr Macfarlane—Again you are getting me back into the area of prudential supervision of banks, so I am not right up to date with that one, I am afraid.

CHAIR—But you would have an overview?

Mr Macfarlane—A particular provision by a particular bank's particular activity is getting a bit technical. I will look into it, but it is a bit technical for me to be able to answer on the run, I am afraid.

Mr WILTON—What does the bank see as being the positive and negative implications of the introduction of the euro on the Australian economy? How would the bank see the development of international financial markets following its introduction?

Mr Macfarlane—I get asked this question quite a lot: what are the implications for Australia of the introduction of the euro? I have been to a number of seminars which purport to tell you the answer. In every case I have heard a long discourse on how the euro will operate, how the European central bank will operate and all that sort of stuff, so I know all about that. But I am not sure I know a lot about what its implications are for Australia. People ask, 'What is the implication for the Reserve Bank? We hold all these international reserves.' For us, it is quite simple: approximately one-third of our reserves have been in deutschmarks—and that is the only European currency that we hold—and they will now go straight into being held in euro. So for us it is a relatively mechanical thing.

For the Australian economy, the only concrete thing that I have been able to come up with is something that is beneficial I think. Currently in Europe, if you were a French insurance company and you had to invest your assets and you wanted to diversify them internationally, some of your diversification would be into Germany, Italy, et cetera. After the introduction of the euro, that will not be diversification at all; they will still all be in the one currency, the euro. So there will be no diversification benefits in that at all. So those sorts of institutions that want to hold an internationally diversified portfolio will have to start moving a lot of the stuff invested in Europe outside Europe. Australia would be an obvious candidate to receive some of that because the economic characteristics of Australia are very different from Europe and therefore there is a diversification benefit.

Mr WILTON—We have discussed the impact of speculative activity on the volatility of the Australian dollar. It has been suggested that, following the introduction of the euro, our dollar may go from being the eighth, ninth or 10th most traded currency in the world to something like the third, fourth or fifth.

Mr Macfarlane—It is not going to go quite that far.

Dr Grenville—It will be the fifth or sixth. Partly it is because some currencies just disappear, so you get there by default.

Mr WILTON—Doesn't that in many ways create the inherent potential for further volatility with subsequent adverse impacts on business planning and investment decisions?

Mr Macfarlane—I sort of doubt it myself. I do not think it would necessarily make a noticeable difference. Can I go back to one of the things the chairman said right at the beginning about how the Australian dollar went up by six per cent in a couple of days—

CHAIR—It was US6c.

Mr Macfarlane—Sorry, US6c in a couple of days, which was the biggest increase and it was some sort of evidence that the Australian dollar was becoming more volatile. The interesting thing there is that Australia had nothing to do with that. That was not a result of anything that happened in Australia or to the Australian dollar; that was simply a reflection. That was our side of this remarkable change that occurred between the yen and the US dollar. It was entirely an external event, so we were just caught up in an external volatility rather than some internally induced volatility. That is interesting. It is saying that the one event you could point to in the 1990s of volatility in the Australian dollar was externally caused, whereas in the 1980s most of the big moves were events that occurred in Australia which led to the change in the exchange rate.

Mr WILTON—If, for example, the dollar is constantly buffeted by euro or non-euro related speculative forces—and by and large that volatility might be reflective, as you said, of its capacity to absorb international shocks—is there anything that the RBA can or should do?

Mr Macfarlane—I want to repeat the previous statement. I do not see why there should be a material change in the variability of the Australian dollar as a result of the euro. You are right to say that we will move a couple of rungs up the ladder of most traded currencies because a couple of individual currencies drop out. I do not necessarily see that as being big enough to make a huge difference. If it did, if it were purely financial market instability which we judged to have no basis in fundamentals and it threatened to cause damaging overshoots in the Australian dollar, it would probably be an argument for heavier intervention.

CHAIR—I want to go back to the question of hedge funds. We did not really get your views on what controls on capital adequacy or so on ought to be there. Is the Reserve Bank taking an active role in international forums to try to promote more accountability from the banks?

Mr Macfarlane—The first thing is, yes, we are taking an active role. We have made our views very clear. As I said, the first official group that is being set up to look at this issue is being set up in the BIS, so it is coming out of Basel. So we will be looking at the Basel arrangements as well as other things. We will have a member on that.

I really cannot prejudge it at the moment other than to say that we have to look at banks' relations with hedge funds and we also have to look at certain markets which have this characteristic. It would get rather technical if I went into it, but some of it is explained in our half-yearly statement. There is a box in the half-yearly statement that explains how certain types of transactions can be geared up infinitely. We will be looking to see whether there is a way around that, to see whether there is a way of putting some regulations at least on banks, which are usually on one side of these transactions. It is the sort of the over-the-counter or the off-exchange derivative markets.

CHAIR—One assumes that you would be more than looking at it.

Mr Macfarlane—I would certainly be hoping to do more than look, but at the first stage you look.

Dr SOUTHCOTT—Hedge funds are mainly instruments in the United States. Are you aware of any Australian banks which have exposure to hedge funds?

Mr Macfarlane—Yes, there are. APRA did a survey of their exposure via lending to hedge funds, but there is also a significant amount of exposure which would be simply as the counterparty to a swap transaction, particularly a foreign currency swap transaction. In most cases the counterparty would be an Australian bank.

Mr LATHAM—What are you hoping the Prime Minister's task force will achieve?

Mr Macfarlane—The main thing that it set out to achieve was a very near term objective. The purpose for it was to make sure that the Prime Minister could go to the Kuala Lumpur APEC meeting and play a constructive role—he did, and Australia did play a constructive role. It was a very difficult and sensitive meeting given the time and the place in which it was held. A lot of the countries in the region were in some sense preoccupied with their own problems rather than thinking internationally. So it certainly, I think, played a very useful role there. It also sort of maps out a contribution that Australia can make to the various international fora which are discussing changes to the international financial system.

Mr LATHAM—Further on the Asian crisis, does the bank feel it could have done a better job in forecasting some of these risks in Asia? My attention was drawn to Dr Grenville's very thorough and well-researched speech on 13 November which gives a hindsight view of how the Asian crisis had emerged. It seems from my reading that it just comes down to a matter of monitoring capital flows and balances. If that can be done after the event, shouldn't it have been done prior to the event and perhaps greater awareness developed about the risks?

Mr Macfarlane—Steve, tell us why you did not forecast the Asian crisis.

Dr Grenville—Again I am asked to talk about my failures. Why doesn't somebody ask me about successes? I think the problem in forecasting it was: we saw the individual elements that were going wrong, but we had no idea that they would in a sense trigger off each other and become more powerful because they would interact and compound. As usual, we had no idea on timing. It had been a well-known fact that banks were fragile in these countries, but it is another thing to say, 'In the next year or so they will come apart.' It was equally likely that they would creep by and after a while get better. I do not want to get into mentioning individual countries, but you can find cases now where there are problems in countries but you cannot sensibly predict a collapse because it is the interaction of these factors. To the extent that they are being changed over time, there is a good chance that they will get by.

The other thing that certainly in my own case made it hard to predict was I had been impressed by the long period of growth which coincided with these problems. For 30 years these countries grew with all of these problems—the problems of weak financial sectors, governance and everything that was discovered afterwards to be critical—yet they had managed to get by for 30 years. The question is: why couldn't they have gotten by a little bit longer and in the process, hopefully, corrected some of those things? So it is a forecasting failure, but it is one that looks a lot clearer after the event than before.

Mr LATHAM—How do you now assess the risk of deflation in some Asian economies spreading further?

Dr Grenville—It depends on the country. I think Korea is maybe at the trough and has some prospect that that will move forward—probably next year. At the other end of the spectrum is Indonesia where there is not really yet a clear definition of a trough or a stability situation reached because that has now interacted with all sorts of political elements as well. In between those you have countries like Thailand. It is hard to make any generalisations about that.

Mr LATHAM—You reject the idea that the lasting legacy of the Asian crisis would be global deflation?

Dr Grenville—I think it is unlikely that the world is getting into deflation. There are a couple of reasons for that. The main reason is that people did learn something from the 1930s and I do not think it is a worldwide phenomenon and it is likely that we would fall into the same problems. These are policy mistakes. It is possible that policy all around the world would get it wrong or policy in all the big countries would get it wrong, but I would have to say I think that is unlikely.

I think that is very different from what is happening in the crisis Asian countries. I do not think that is a process of deflation in the same way that you might have had it in the 1930s. This is a series of problems which have interacted with each other to make it very difficult for these countries to grow for some time. Somehow they have to work their way through that series of problems. But it is not like the 1930s. I do not think that is the analysis.

Ms BURKE—Going back to hedge funds, some of the market speculation is that the crisis has now passed in respect of the volatility of them because banks will not lend because they have been burnt. So there is a view out in the market that we have missed the boat for regulation of them. Would you share that view or not?

Mr Macfarlane—There is an element of truth in that because I have seen estimates that they have lost up to one-third of their capital by betting the wrong way on the yen and the Hong Kong dollar and also because of the losses they incurred in Russia. It still does not mean you should not make a better system. They will be back in a couple of years and we want to have a better system for them to operate within.

CHAIR—We might move on to a couple of other issues. I was wondering whether you would like to comment on how the arrangements with APRA are working. Is there anything still to be resolved, et cetera?

Mr Macfarlane—I think it is working pretty well. I am a member of the board of APRA, as is another member of my staff, Dr Laker. You will be aware that the CEO of APRA is Graeme Thompson, who was formerly Deputy Governor of the Reserve Bank. So relations are very cooperative. I do not think there is a problem at all in APRA's relations with the Reserve Bank.

I think the more difficult issue they are grappling with is how do they get a common approach to supervising entities as different as a bank, an insurance company and a superannuation fund. I am not sure how far it will be possible to come up with a common approach or even whether it is necessary. But, given they are all in the same institution and the experts talk to each other and they report to the same people, they will get some coordination that way.

The relations with the Reserve Bank are going extremely well, even though the banking supervision part of APRA has only recently physically left the Reserve Bank to go to the new APRA headquarters. It is going very well. The next step will be to get the state based supervisors of the credit unions and building societies to join. That will occur some time next year.

Mr WILTON—You may have answered this a little earlier on, but should APRA have any sort of direct control over hedge fund speculation?

Mr Macfarlane—The answer would be: only in so far as it has prudential implications. That is what their answer would be, which is the correct answer. They would be interested only if they thought that the relations between an Australian financial institution and a hedge fund threatened the solvency of the Australian institution. That would be extremely unlikely. If they thought there was even a remote possibility of that, they may ask for some disclosure or some reporting.

Ms BURKE—In respect of APRA—and it is an unfair question in some respects—do you know how the discussions are progressing in respect of the states and the transfer of credit unions and building societies?

Mr Macfarlane—No, I am not on top of that. My mind wanders when I hear those discussions because it has always, as you know, been difficult in federal-state relations and for states to cede powers federally. So far as I can see they are definitely on track, but it has taken a bit longer than people hoped for.

Ms BURKE—Yes, it was meant to happen at the beginning of next year and it is now not until July. Do you think the delays are normal?

Mr Macfarlane—Yes, I think they are just the normal delays that occur in those circumstances.

Ms BURKE—Do you believe the 60 Reserve Bank staff who have gone across to APRA are not going to suffer any financial loss because of the change in working conditions?

Mr Macfarlane—Broadly speaking, yes, I think that is the case.

Mr LATHAM—I have a question for the governor and it follows on from some things that were said at the May hearing in Melbourne. How is that speech on national savings coming along?

Mr Macfarlane—I have not made much progress, I am afraid. Other more pressing problems have got in the way. Thanks for reminding me. I will make sure it is on my work program.

Mr LATHAM—Is there a change in bank policy? I know Bernie Fraser was always saying a fair bit, despite political controversy, outside the area of monetary policy. He would often say things about labour market programs, unemployment and the like. Under your governorship, is there a policy now of sticking closer to monetary policy matters and not venturing into other parts of the macro economy?

Mr Macfarlane—I do not think so. I certainly have said a fair bit about employment and unemployment. I have said a lot in the last couple of years. I have said an awful lot about international matters. Five years ago, people would have been surprised if the Reserve Bank were talking so much about that. I do not think there has been any change there at all.

Mr LATHAM—What then did you think of the intervention of the five economists suggesting a real wage tax trade-off as a way of addressing unemployment problems in Australia?

Mr Macfarlane—I think their proposal is one that has to be taken quite seriously. In the past, there have been a lot of people who have proffered views on the unemployment problem but, when it came to solutions, they did not think very creatively or their solution tended to be utterly predictable. If it was a chamber of commerce talking, you knew what they would say. If it was a union, you knew what they would say.

The interesting thing about this proposal is that it comes from people of varied political backgrounds and it accepts that there have to be a number of changes made. It is not just a matter of expecting the other person to give up something. It accepts that prices and wages do matter but, on the other hand, the burden should not be borne entirely by people at the bottom, but the taxpayer should also bear a burden. In fact, they should bear the burden rather than just the people at the bottom. I have not read it in detail. I have read the letter and I read articles some time ago that Dawkins put out, but I think it should be taken very seriously. It is about the most constructive thing that has come along in this area for years.

Mr LATHAM—Is the bank still supportive of labour market programs as a way of dealing with rigidities in the labour market? Therefore, you would perhaps be a bit critical of the current government's cutback in that area.

Mr Macfarlane—I am not sure that the bank ever had a particular developed view on labour market programs, so I am not aware that we would have changed our view.

Mr LATHAM—Bernie Fraser was quite strong at these hearings in supporting their role in freeing up labour market rigidities and dealing with long-term unemployment problems.

Mr Macfarlane—We are certainly in favour of freeing up labour market rigidities. You would have to see the program. The devil is in the detail on all these things. I have no in principle objection and I have no principle in favour. I would have to see the program and be confident that you were getting value for money. Most of the people I know who have looked at these things think some of the programs are good and some of them are hopeless.

Mr WILTON—The goal of full employment is still a stated component of the bank's charter. Is this goal, however, now largely outside the bank's influence? For example, if rates were sliced by a further two per cent, would any entrenched boost to employment result, or do structural issues really now dominate?

Mr Macfarlane—It is a very good question and it would probably require a long paper to answer it adequately. Structural issues are important, and I think everyone would agree that structural issues mean that at this stage it is inconceivable that through macro-economic policies you could return to the unemployment rates we had in the 1960s. I think it is accepted that structural issues are such that a full employment rate of unemployment, or the NAIRU, is higher than it was then.

On the other hand, we do believe that good monetary policy can make a contribution to getting you to wherever the appropriate structural level of unemployment is. We also believe that the inflation targeting approach actually will achieve that for you in the long run. The inflation targeting approach is not an anti-growth policy at all; it is a policy that says you are trying to get the economy to grow as fast as possible consistent with low inflation because you know that is the surest way of getting a long expansion in economic activity, and a long expansion in economic activity is really what you are after.

If you go back and look at the unemployment problem from a macro-economic perspective in Australia, you find that the problem is not that we did not grow fast enough in our expansions; the problem is that we had three deep recessions. Two of them actually occurred in the period from about 1973 to 1983, and that is what got us from being an economy with two per cent unemployment to an economy with 10 per cent unemployment. We painfully got it down from 10½ per cent to six per cent during the eighties expansion and we lost it all again in the nineties. We went back to 11 per cent and we are painfully getting it down again now.

The aim of the exercise is to have long sustained expansions and to try to either avoid recessions or, if that is not possible, have as mild a ones as we possibly can. In the long run, that is the contribution that macro-economics can make to reducing unemployment. If that is too slow, you have to look for something that is more radical. That is where things like the proposal by the five economists comes in.

Dr SOUTHCOTT—Do you have any concerns about the decline in household savings that has become quite dramatic over the last two or three years?

Mr Macfarlane—Glenn, you have done some work on this recently. Could you explain?

Mr Stevens—Obviously, if that decline were to continue, one would have to ask questions about whether there was enough saving going on in some longer term sense. This is an issue that also comes up in the US in fact. One of the risks that people point to there is a savings rate of zero and what might happen if people suddenly decided they needed to save more.

One of the factors I would point to as a longer run structural adjustment that is going on is that in the eighties financial liberalisation really meant that companies got major benefits in terms of finer pricing of financial products and so on and the competitive forces really chased the corporates. In the nineties, those competitive forces have been directed towards the households much more. It seems to me plausible to expect that, as you have liberalised and as these forces of competition and so on take place, a lot of households will decide that they are going to run higher debt than they used to and in the process they are going to be spending more relative to current income—that is, the savings rate will be lower while this adjustment to higher levels of debt takes place. If that is the right view, then at some stage when they reach a kind of financial condition that they are happy with, the savings rate will come up again and the rate at which borrowing is expanding—which has been quite fast and continues to be quite fast even now—will come down a bit.

Where we are in that adjustment is what is hard to know. I think there is a question mark there about the extent to which households can continue to go into debt at the rate they have been. Their debt levels are now middling by international standards. They used to be low, now they are probably average for a developed country. At some stage, that probably ought to slow down. I am reminded of an economist who once said, ‘If something can’t go on forever, it won’t’ and so you shouldn’t panic about it. It is a question that we ask, but I am not sure we can have a dogmatic view about whether what has happened to date is necessarily bad or whether it is just a normal response to the changes in the financial environment that have been taking place.

Dr SOUTHCOTT—Mr Macfarlane, earlier you mentioned the NAIRU. The United States have had a period where their unemployment rate has been below five per cent, which they consider full employment, without inflation taking off. There is a feeling that the NAIRU has declined in the United States for a number of reasons. Do you get the feeling that a similar process is happening in Australia, whereby we could have these growth rates of five per cent and not run into an inflationary crunch? Do you think labour market reform is having any impact on that?

Mr Macfarlane—It is conceivable. What happened in the US, essentially, is that the economy continued to grow faster than they thought without putting significant upward pressure on prices. So until there was significant upward pressure on prices, they just let the economy run, which is exactly what we would do. That is the underlying inflation targeting model.

This happened year after year in the US. They discovered that the rate of unemployment went below what they previously estimated the NAIRU to be. Inflation did not go up, or it went up by only a very insignificant amount. This suggests that the previous estimate of the NAIRU was not correct or that the new one had edged down. That procedure is possible in Australia. The only problem is that we started from a much higher level of unemployment. We have had an expansion that is just as long as the US expansion. It has been going for 7½ years now; we are in our eighth year. We are striking a rather unhelpful external environment at the moment. However, in principle, the same discovery process that occurred in the US could happen here. I would be very surprised if we discovered that our unemployment was as low as theirs.

CHAIR—Let us look forward to the year 2000. I understand that the Fed is rather concerned about what it may mean in terms of ATMs and EFTPOS and so on. It has stated that it is prepared to issue $50 billion. What preparations has the Reserve Bank made for this in that regard?

Mr Macfarlane—We have more stocks of currency on hand. We have been both printing more and not destroying old notes. We are building up higher stocks. Two things could happen in this aspect of the year 2000. The issue of most relevance to us is the public's demand for notes and coins. Firstly, there is the normal sort of precautionary behaviour that you would expect any rational person to do. That is to say, 'I'd better have a bit more money in the wallet over that long weekend than I normally would because the ATMs might break down' or something like that, even though a massive amount of money goes in to make sure that these things do not break down. There is that normal precautionary desire to have a bit more. We will ensure that there is more than enough to handle that.

The other thing that could happen—which I do not think will happen, although there is always this little nagging fear—is that there will be some generalised panic on a bigger scale. People will start to worry that their whole bank balance is going to disappear in a flash as we pass the year 2000. I would be very disappointed if we had a huge irrational panic of that nature, although we are fully prepared for a rational precautionary increase in the public's holdings of notes and coin.

Mr WILTON—The expectation in the bank bill futures market is that rates will rise in the last quarter of next year and possibly in the first quarter of the year 2000 because of the retention of cash by private sector companies et cetera. Is that something the bank fears? What educational campaign can you run in that regard?

Mr Macfarlane—I think you are right. It is very important to have an educational campaign to try to counter the irrational fears. There are rational precautions. I think the fear is in conspiracy stories and wild ideas, which start spreading over talkback radio. You get all sorts of people doing funny things. It is important to have a public education campaign on that. The main thing we can do is make sure that we have enough notes available. We are already well into the process of making sure that we have enough notes on hand so that the public can hold more than normal if they wish.

Ms BURKE—The public payments system will be 2000 compliant as well. I do not think there has been a lot said about it. If you listen on talkback radio to people's experiences with some banks, such as how they do transactions and what they get in statements, you would believe that the irrationality is based on facts, unfortunately.

Mr Macfarlane—The part of the payments system that we are responsible for is the core of it. It is the high value part of the payment system, the real-time gross settlement system. Fortunately, it has only very recently been built, which is a great advantage. We have certainly been over it with a fine-toothed comb. We are confident that it is year 2000 compliant. If you define the payments system much more widely, you have to bring in the telephone system, the telecommunications lines and all that sort of stuff and the electricity supply. You have then almost brought in the whole economy.

Mr LATHAM—I think the governor should get on the Stan Zemanek program.

Dr SOUTHCOTT—If the bank is not prepared for irrational responses, what would be the rational thing for a punter to do?

Mr Macfarlane—If, for example, at one minute past 12 we all say, 'Gee, I wonder whether the telephone is working,' and we all pick up the phone instantly, no-one would get a dial tone. All systems are designed for a reasonable amount of usage. Nothing can be made fireproof for all eventualities.

CHAIR—Is that a confident response?

Mr Macfarlane—Even if the telephone system is working absolutely perfectly—not one chip in the whole system is year 2000 noncompliant—it cannot handle 100 per cent of the Australian population trying to use it at any one time. It is designed for 15 per cent of the people at any one time using it. We all cannot get on one train or one plane tomorrow. Systems are designed for normal usage. Nothing can be designed for an infinite amount of usage.

CHAIR—But doesn't that beg the question? You have a year 2000 project involving the banks. Is that running according to schedule? More importantly, if you are anticipating this possible problem, what more should be done from a public education point of view? What role does the Reserve Bank play in that?

Mr Macfarlane—I will get Stephen to talk about what the banks are doing. If there were this widespread fear in the community that all their savings were going to disappear because the only record of them were these electrons spinning around a circuit somewhere and someone was going to turn off the circuit and it was all going to disappear, there would be a case for public education and public reassurance. That would involve making sure that there is a hard copy of every bank account in the country. That sort of thing is possible. We would make it clear to the public that that has been done. So you can do more than just make reassuring statements. There are ways of doing concrete things to reassure people.

CHAIR—But wouldn't you be advocating that?

Mr Macfarlane—It is the sort of thing we are looking at very closely, but at this stage it is still something we are looking at.

Dr Grenville—On this question of public communication and so on, in the middle of the year, in July, APRA and the Reserve Bank put out this publication which I am holding. If members of the committee are interested, I have spare copies for them. This publication talks about the year 2000 in preparation for the banking system. Just to cut a long story short, that is broken up into bits and pieces. For the individual banks, the main responsibility for that rests with APRA. That is why this is a joint publication with them. On that, Australian banks are at best practice on these. There are timetables in place. There was some discussion of this in our last annual report. So you will see some of the details of that program, and we can tick off the various milestones as we pass them.

As far as the Reserve Bank goes, our responsibilities are really twofold: to make sure the payment system works properly, because that is obviously still in our area; and to make sure our own internal systems are working well. On both of those, again we have a timetable. We started on the exercise of the payment system in April. A test strategy was designed in April 1998, and that external testing is taking place now. There are various streams of the payment system and so the degree of testing varies, depending on the stream in the payment system. But we are on schedule for that testing in the payment system. Internally we have a steering committee that looks after the problems as we see them. So we are doing the things which are done by prudent people all over the world. We have set a program, we stick to it and we are looking for that to address the problem.

CHAIR—You mention the payment system which has been brought in. Have there been any difficulties with that? Is it running at speed now?

Dr Grenville—Not so far. All the testing is not complete and, at this date, all the streams of the payment system are not at the same degree of readiness. But so far it is running to schedule.

Mr WILTON—With rates being relatively low, private sector indebtedness is growing at pretty alarming levels. Is that something that is causing the bank concern; and, if so, what might it do about it?

Mr Macfarlane—That question is not the same but it is the first cousin of the question that was asked about low savings. In the process of answering that, in that one you mentioned some of those considerations. Do you want to just spell that out a bit more specifically in terms of indebtedness?

Mr Stevens—It is worth, I think, just putting in a little bit of history here. The main place where indebtedness has gone up in the past seven or eight years, as I said earlier, is amongst households; in fact, corporate leverage is in very good shape at the moment. Households are carrying a lot more debt than they used to. If we do international comparisons here—and that is hard to do, but we have done this in the past—what we find is that, if you were to go back 10 years, things like debt to income ratios for households in Australia were extremely low by the standards of other developed countries. As I said before, they are now probably in the middle of that range. Were they to keep rising as they currently are, in five or 10 years from now they would be at the top.

So is that a problem? I think it was inevitable that the process of liberalisation of the financial system generally over a long period would lead some people in the community to have higher levels of debt. They were probably constrained from having the structure of a balance sheet they really wanted before, and they are now not constrained. It is also true that their holdings of assets are going up at the same time. So assets relative to income are also bigger now than they used to be. Nonetheless, I think it is true to say that the household sector is more leveraged now than used to be the case. I do not think it is alarmingly so, but it is something that obviously we keep an eye on.

One of the things that has made it possible is that low inflation and extremely low interest rates have brought down the servicing costs. It is a lot easier to carry a fair bit more debt now than it was when mortgage rates were, on average, some double-digit number and cycled around much higher levels. So that is another part of the adjustment.

Ms BURKE—The Reserve Bank is not missing out on the wonderful competition policy itself, and you will be facing tendering for government businesses in the new year. There is a belief amongst some of your staff that you will actually miss out on that process; that the other banks will be favoured over you, even if you are equal in ability to deliver the service. Do you share that view of some of your staff; and, if so, does that mean there will actually be a reduction in competition amongst the banks if you are not in there offering services as a bank per se?

Mr Macfarlane—The situation is that we have done the transactions banking business for the government and for a lot of government instrumentalities for a long time. There is nothing in the act that says they have to use us; they have always just been happy to use us. But now, with the competitive neutrality conditions, the government, the Department of Finance, has told government authorities that they should put their banking business out to tender, and we will be part of that tender process.

Our feeling is that the big users of transactions banking who have been customers of ours for a long time are very happy with the service they get. So our expectation is that they will probably be happy staying with what they have been comfortable with. But we cannot predict this with any certainty. I might add that the policy sensitive aspects will stay with the Reserve Bank anyhow, the government's foreign exchange transactions will continue to be done through the Reserve Bank. The balances at the end of the day will be swept back to the Reserve Bank, even if another bank is doing the transactions during the day.

So the aspects that affect the conduct of monetary policy will not be affected in any way. Also, as I have said, the big customers that we have have been very happy with the service that they have received, and I would be surprised if they want to move—although they may.

Ms BURKE—I have one question that is totally unrelated to anything we have been talking about. Has the Reserve Bank been approached by the Australian Bankers Association to change its reporting structure on bank representation; and, if so, what has the bank's response been to this approach?

Mr Macfarlane—You have got me there. Have we been approached by the—

Ms BURKE—Australian Bankers Association.

Mr Macfarlane—The ABA.

Ms BURKE—Yes, to change its reporting structure on bank representation.

Mr Macfarlane—I am not even sure that I know what a reporting structure on bank representation is.

Ms BURKE—There is a bank representation that goes to you from the ABA. Supposedly, they have approached the Reserve Bank about changing that representation.

Mr Macfarlane—I am not aware of that, I am afraid.

Dr SOUTHCOTT—The Local Government Association have recently in New South Wales said that they will be going into banking. You are no longer responsible for prudential regulation but you are responsible for the stability of the financial system. Are you happy that Bendigo community banks and LGA banks will be adequately supervised?

Mr Macfarlane—That is entirely an issue for APRA. APRA can set the conditions that you need to meet to get a banking licence. So it will set some conditions whereby, if met, it will be confident that that institution will be sound. That is entirely an APRA matter.

CHAIR—Someone did suggest that in a previous parliament one member used to ask you when the folding stuff would actually fold—say, when the five-dollar note would fold. Did we make any progress on it?

Mr Macfarlane—My recommendation is to keep it flat; I do not really find a great need to fold bank notes.

Ms BURKE—Is there a concern with note printing that we are not competitive in that environment as well?

Mr Macfarlane—We are doing pretty well. We are winning overseas customers each year. We might be able to do better. But we are certainly absolutely confident in the technology—that it is a big improvement. A number of countries have moved in that direction. We think it is coming along quite well.

CHAIR—I think we have had a very good innings. Mr Macfarlane, Dr Grenville and Mr Stevens, thank you very much for coming along today and for your willingness to answer all the questions that the committee has thrown to you. We will probably meet again in May in Melbourne or Sydney.

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 1.22 p.m.