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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

Thursday, 17 June 1999

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

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

Terms of reference for the inquiry:

Review of the Reserve Bank of Australia's annual report 1997-98.

WITNESSES

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia 43

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia 43

STEVENS, Mr Glenn Robert, Assistant Governor (Economic), Reserve Bank of Australia 43

Committee met at 10.02 a.m.

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

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia

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

CHAIR—I welcome everyone here today, and I declare open this public hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration. I particularly welcome the representatives from the Reserve Bank, members of the public and also the media. In 1996 the Governor and the Reserve Bank agreed that twice a year the Governor would appear before this committee to answer questions about the conduct of monetary policy and issues outlined in the bank's latest semi-annual report. The Reserve Bank's annual report for 1997-98 provides another basis for today's inquiry.

The bank has participated in these hearings for a number of years and, as both the bank and the committee have acknowledged on many occasions, these hearings provide an excellent opportunity for the parliament, the financial sector and the wider community to monitor the way in which the Reserve Bank conducts its business and makes its decisions about monetary policy. It is also a good opportunity for the committee to follow up other issues of public importance such as recent surveys that have been released by the bank on bank charges and what affect that has on bank customers and other issues like preparedness for the Y2K challenge.

New research by the Productivity Commission shows the Australian economy is on a new growth path with the potential for faster growth and rapid improvement in living standards. Monetary policy is going to play a critical part in that, and the Reserve Bank, which has the responsibility for the conduct of monetary policy, can help explain today whether it sees this growth path as sustainable. No doubt there will be many other issues that we will canvass today, and we look forward very much to those hearings. So, with that, let us see what insights we can glean today from our witnesses.

I will proceed immediately to the procedures to calling the Governor and other senior representatives of the Reserve Bank. Accordingly, I welcome here again representatives from the Reserve Bank. I remind you that the evidence that you give at this public hearing is considered to be part of the proceedings of the parliament. I, therefore, advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of parliament. Mr Macfarlane, would you like to now make an opening statement before we proceed to questions?

Mr Macfarlane—Yes, I would like to do that. Thank you for your introduction. I remark what a pleasure it is to be in Melbourne again in these very delightful surroundings and in front of this committee again. Like last time, the *Semi-annual statement on monetary policy*, which is an integral part of these committee hearings, was released a month before the hearing. On this occasion it was the budget that caused the delay in the hearing, but I do not think it is a serious matter because the statement is still relevant. If anything, the advance

release of the statement may have been helpful in giving more time to digest the material that is within it. As you mentioned in your introduction, more recently we have sent to the committee some new material in the form of a paper on bank fees.

I would like to start off in my customary manner by comparing what I told you last time with what now appears to be the likely outcome. I do this in the interests of accountability and also because I think it has the advantage of drawing out the limitations of economic forecasting and the necessity of seeing policy formulation as an iterative process. Last time—that is, in December—I indicated the expectation that our growth rate was likely to be lower in this financial year, 1998-99, and that there would be some pick-up in inflation, though at a rate consistent with our target. I said that the current account deficit would expand and it would probably reach six per cent of GDP on a quarterly basis at some stage. In fact, I have been saying that for more than a year. I indicated that not a lot of further progress could be expected in reducing unemployment from the rate of 7.9 per cent which had prevailed in the three months before the hearing.

It is now well known that growth has not as yet declined. The growth rate up until the March quarter of this year is still well above four, 4½, 4¾ per cent. In all likelihood, growth for the financial year 1998-99 will have been in excess of four per cent, whether it is measured on a through the year basis or on an average of year basis. This makes this expansion, which began in the middle of 1991, the longest continuous upswing since the 1960s. Nor is there any sign yet that the expansion will come to an end. When I say 'come to an end', I mean the expansion comes to an end when you have a recession. There is certainly no sign of that. Although we clearly are of the view that some decline in growth is very likely, but from a considerably stronger starting point and, of course, much more delayed than earlier thought.

The outcome for the calendar year 1999 will, in our judgment, be lower than the growth recorded in 1998—something between three and four per cent is our guess—and probably slightly lower again in the financial year 1999-2000. This is a fairly mild decline, given the size of the external shock to which we have been subject. More importantly, I think the atmosphere has changed since we were here in December, in that the risks of a sharp slump in the world economy have lessened considerably since we last met. Last December we had just been through a period in which confidence in the prospects of the global economy—including, of course, the US economy—had reached its lowest point. Behind this were concerns about the extreme instability of global financial markets and the possibility of a credit crunch. Since then, the US economy has continued its strong performance and concerns about credit crunches have disappeared. Indeed, there is now a widespread expectation that the strength of the US economy means that a tightening of US monetary policy is on the cards. Evidence has also continued to accumulate of a turn for the better in the countries of East Asia, which slumped so sharply during 1997 and 1998.

Inflation in Australia meanwhile has risen, but very slightly and considerably more slowly than our central forecast of six months ago had suggested. In our latest statement, we have forecast inflation to be about two per cent in underlying terms by the end of 1999, and in headline terms the CPI is also likely to be about two per cent. This is a little higher than we suggested in the half-yearly statement as we have now taken full account of higher international oil prices, which will roughly offset the effect of the health care changes.

The current account deficit has turned out to be something like 5½ per cent of GDP, we think, in 1998-99—we have not quite finished the financial year. It was almost six per cent in the March quarter. It is highly likely that a quarterly figure of over six per cent will be recorded in the June quarter. It seems to us that numbers something like this could well be seen over the next few quarters, with the result that the outcome for 1999 as a whole will be about six per cent of GDP.

The unemployment rate has fallen further, in line with a stronger than expected growth in the economy. Over the last three months it has averaged 7.5 per cent compared to 7.9 per cent for the equivalent period immediately before our last meeting. Given the amount of growth we have had over the past year, some further moderate decline in unemployment will probably be recorded in net terms over the remainder of this calendar year. That is my summary of what we said, what happened and what we think now is going to happen.

Even though the outcome has been better than expected, if someone wanted to score a point they could say that we are not very good forecasters because this is the second time in a row where the outcome has been much better than our forecasts. I would have to concede that we have been a little conservative in our forecasts, but it has not led us astray in a policy sense—that is, it has not jeopardised the achievement of a good economic outcome.

As someone who has been involved in forecasting and economic policy in the lean years as well as in the good, there is a more interesting question that I think has to be asked, and it is this: how is it that the Australian economy has been able to grow at 4½ per cent plus per annum in the seventh and eighth years of an economic expansion without generating significant wage and price pressures? It certainly was not able to do so in earlier expansions.

I have already given part of the answer to this question in my December testimony and in a couple of speeches since. It is that the economy has achieved improved productivity growth as a result of the micro-economic reforms of the past 15 years. The main changes have been reductions in tariffs, privatisations, financial deregulation, competition policy and labour market reforms. Of course, businesses have also become much leaner and more adaptable, irrespective of government policy changes, as they have responded to increased competitive pressures. The key piece of evidence for this is the one that was mentioned by the chairman in his introduction, that is, the higher growth of multifactor productivity in Australia in this expansion compared with previous ones. A lot more could be said about this subject, but I will leave it to others and move on to a related subject.

It seems to me to be quite possible to have higher productivity growth and yet to still encounter macro-economic imbalances, which would bring an economic expansion to a halt. In other words, higher productivity growth can explain why the economy's average growth rate is faster, but I do not think it can provide an adequate explanation for why the expansion will last longer. To do this, I think a macro-economic explanation is required. And here I come back to low inflation and low inflationary expectations, which have characterised the 1990s expansion but were clearly absent from earlier expansions. As the earlier expansions matured, inflationary pressures built up which simultaneously pushed up prices requiring a monetary policy response and squeezed businesses and business confidence. In the mid-seventies and early eighties the expansions came to an end with a

wage explosion, whilst in the late eighties it was an asset price boom and bust. This time we have had neither of these.

Low inflation has certainly helped in the wage bargaining process. It has certainly helped prevent wage explosions. Employees have seen that quite modest nominal wage increases have translated into decent real wage increases because inflation has been contained. They have not had to build anticipatory wage increases into their wage bargains to safeguard themselves against inflation getting away from them. Increased flexibility in industrial relations arrangements has also helped.

Similarly, low inflation and low interest rates have had a favourable impact on business behaviour. An important reason for this is that with low interest rates there is little or no scope for negative gearing. Most of the reckless schemes of the entrepreneurs of the 1980s was simply negative gearing writ large. This was the biggest contribution to the boom and bust in asset prices. It was not the only reason—I accept that the rapid increase in the number of lenders associated with the deregulation of the finance sector also played a role. We could argue about the relative weights of these two factors if we wish, but the relevant fact for today is that neither of these two factors is present in the current expansion.

That sounds pretty optimistic. It is argued that we do not seem to be developing our usual ailments, but are there some new ailments that may bring our progress to a halt? It is rather difficult, I think, to identify any new ailments, but one that has attracted a bit of attention lately is the fall in the household saving ratio. In contrast to the business sector, which has become more cautious in the 1990s, the household sector has become less cautious, as shown by the household savings ratio falling from 12 per cent in the first half of the 1980s to about one per cent at present. This has been a pretty steady downward trend, as members of the committee can see from the graph that is contained in the handout. The second piece of evidence here is that household borrowing has risen as a percentage of annual income. People are saving less and borrowing more.

This less cautious attitude by households is a surprise to many people because it seems to be at odds with the usual media depiction of a public worrying about its future, anxious about job security and generally insecure. If we were instead to judge the public by what they actually do, we would conclude the opposite. Unlike their parents and grandparents, who saw a great need to save for a rainy day and who had the privations of the Depression still in their minds, the spending and saving pattern of the current generation indicates a totally different attitude. Of course, developments on the supply side have made this a lot easier. At today's low interest rates, it is possible to service a much bigger loan than it was at the start of the decade. Also banks and other financial intermediaries have found new ways of providing credit based on previously inaccessible collateral.

The important issue for us is whether this trend change in household behaviour is going to cause problems for the economy, particularly whether it is going to endanger the present expansion. I think there are three possible problems that could arise, so I will discuss each one briefly. The first possible problem is that if inadequate household saving persists it could mean inadequate provision for retirement. This, in turn, would put increased demands on future taxpayers. This is an issue of intergenerational equity. I do not want to suggest that

this is not a problem—it may well be a big one, but the solution to it would be found in improvements to our policies regarding retirement income.

The second possible problem is that any reduction in saving, other things being equal, would lead to an increase in the current account deficit. Has the trend decline in household saving over the past decade caused the balance of payments to deteriorate? The answer seems to be no. The current account deficit has shown roughly the same cyclical movement that it has exhibited over the past 20 years, but no change in trend. You can see that from the second graph that is contained in the handout.

The reason for this is that, even though household savings have gone down and the current account has remained fluctuating around a flat trend, there is no one-for-one relationship between household savings and the current account deficit. We have to also take into account government sector saving, business sector saving and, of course, investment before we get to current account and the balance of payments, and movements in some of these factors have offset the reduction in household saving.

The third possible problem is that increased indebtedness makes the household sector more vulnerable when interest rates rise. This is probably true, but the main implication is that, to achieve a given macro-economic effect, interest rates would not have to be raised as much as was formerly the case.

I now want to turn to a totally different subject that is going to be extremely important over the next seven months; I refer of course to the issue of the end of century date change, or Y2K as it is commonly known. I have been warned by my former colleague, Graeme Thompson, that they should not use the term Y2K because, he said, ‘That's how we got into this problem in the first place, by using an abbreviation.’ But it seems to be the one that has caught on, so I will continue to use it. Everyone knows what the Y2K issue is by now, so I am not going to explain what it is, but I want to say a few things about the Australian economy, community and particularly the finance sector's capacity to withstand it.

The main point I want to make is that the Australian financial system is extremely well prepared for Y2K. The formal process of fixing and testing their systems began in the mid-1990s and it has been under the scrutiny of APRA and the Reserve Bank since early 1997. Financial institutions have devoted over $1 billion and thousands of staff to checking and updating computer systems. Where problems have been found, they have been fixed. Outmoded ATMs and EFTPOS machines have been replaced. Computer programs have been rewritten or new software has been installed.

With all this effort, the Australian financial system rightly enjoys a world-class reputation for its high level of Y2K preparedness. I should add that the Reserve Bank's own computer systems are of course year 2000 ready. In particular, the systems that the Reserve Bank uses to distribute pensions and other government payments to banks, building societies and credit unions on behalf of Centrelink have been thoroughly tested. Pension payments will be made on time.

So much work has now been completed to ensure the system works that the big issue facing us is no longer a technical one; it is, instead, an issue of public reaction. While I am

very confident that the overwhelming majority of the Australian public will act sensibly, there are no doubt a few who are inclined to believe doomsday scenarios. With this in mind, there are a few preparations that we at the Reserve Bank have been putting into place to help reassure the community.

An important step was to talk to the banks, building societies and credit unions to make sure they were communicating with their customers in clear language to reassure them that their deposits were safe, because the simple fact is that their deposits are safe and their records are not at risk from Y2K related problems. All financial institutions have extensive backup systems to ensure that each night they keep multiple physical records of all account information. While some members of the public have expressed concerns for the safety of their deposits because they think records might disappear, there is no basis for this type of concern. The safest place for people to keep their savings is in the financial institution that they are already with. Withdrawal and conversion to cash would expose them to a lot of unnecessary risks.

The vast majority of people, I believe, do not have these concerns, but they do still have a few uncertainties. Many will wish to take more cash out to tide them over the New Year period than they normally do. To this group I just want to make a few points. The first one is: do not for a minute fear that you need to take out more cash because there may not be enough to go around. There will be. The Reserve Bank has printed and is carrying in stock a lot more notes than usual so that it can meet any conceivable increased demand.

If you are worried about high-tech systems such as ATMs or EFTPOS letting you down, remember that you are only dependent on them for the first three days of the New Year. After that, the banks, building societies and credit unions open their doors again and you can go back to the old-fashioned way of obtaining cash. You are really only dealing with a long weekend. Even in those three days of the long weekend you are not completely dependent on cash: credit cards can, if necessary, still operate in their traditional paper base mode and cheques can be used as normal. So I think there is a tendency to exaggerate the size of the problem that people are facing. In our view, it is really only a matter of facing another long weekend. Then, at the end of that long weekend, you go back to doing things exactly the same old physical way as you were doing them before. So, in my view, you really only need to take out enough money to cover you over a long weekend. That is what I will be doing. Those who want a little extra reassurance in the form of extra cash can be confident that it will be readily available.

That is all I wish to say in general terms about Y2K at this stage, but I will be happy to answer any detailed questions you wish to put to me. I am also conscious that I have been talking for quite a while so that I have not left any time to cover the subject of bank fees. But with a copy of our paper at your disposal I am sure you will find plenty of material to supply you with questions on that subject. As usual, I am only too happy to answer any questions you may wish to put to me on the economy. Thank you very much.

CHAIR—Thank you very much, Mr Macfarlane. First of all, I commend you on that very comprehensive introduction. I am sure that everyone who has heard it will be very reassured by some of the comments you have made. For those who wish to get a copy of your speech I think it is now available over there on the table. I also note your comments

on, shall I say, the Year 2000—to get the right jargon. I am very impressed that you said you will be just treating it like another long weekend. I can see you will probably have to take a public advertisement somewhere nearer the time saying, 'I'm not worried, so why should you be?'

Mr Macfarlane—It will be different from a long weekend in one respect in that I suspect that I will be at work for some of the long weekend.

CHAIR—Maybe we could start off, as usual, with questions about monetary policy. I note your reassurances, but you did talk about widespread expectations of the US economy meaning that a tightening of US monetary policy is on the cards. I guess there is nothing new about that. That expectation has been around for a while. To what extent would a tightening of US monetary policy influence Australia's monetary policy settings?

Mr Macfarlane—In order to answer that, the first thing you have to do is look at the situation of the US economy and then compare it to the situation of the Australian economy. The broad factor that underlies the US is that its economy had been growing very quickly—as our economy has been growing very quickly—but there was a very strong belief in the US that it was approaching capacity constraint. It had already passed what they thought was full employment and they had this looming capacity constraint. If you remember back into the middle of last year, there was already a widespread expectation then that the US would tighten. In fact, the Federal Open Market Committee had a recommendation that they had a bias to tighten—in other words, they were saying in a sense that the next move would be up. Then we had this very disturbed period in international financial markets around the August to November period with the Russian default, the Brazilian problem and the collapse of Long-Term Capital Management.

Suddenly, there was this fear that there was going to be a credit crunch within the US—that the lenders would not lend to anyone other than the highest credit risks. So, very quickly, the US eased monetary policy three times between the August and November period. This was a remarkable turnaround. Here was an economy which in the middle of the year everyone thought was approaching full capacity and growing too quickly, and yet, in the second half of the year, they eased monetary policy three times to overcome a temporary problem, which was the credit crunch. Then, as I said, the fear of the credit crunch went away. So everyone then looked at the US and said, 'The reason for those three easings has now gone away. It is just a matter of time before the US moves its interest rates back up to somewhere near where they were before this fear of the credit crunch arose.' So that is the central background fact about US monetary policy. They did these three easings, which no-one had predicted, for a temporary purpose. That temporary purpose has now gone away, so how will they move their rates back to normal, as it were?

When I explain that, you will of course realise that there is no such similarity in Australia. We did not have a fear of a temporary credit crunch. We did not have to do, in some sense, an emergency operation on monetary policy to overcome this temporary problem, so we are not in a position where we now have to unwind that emergency operation, which is what people view the US as having to do. That is why US interest rates have been driven up virtually continuously through 1999, and that is why the money markets in the US have fully priced in a tightening at the next meeting of the FOMC. I am not

going to say whether I think the Fed will tighten or not, but the US money markets are completely confident that there will be a tightening on 30 June.

You might be aware that some figures came out last night on the US CPI, which people watch very closely. They have monthly figures—we have quarterly figures—and the figure that came out last night was zero. Some people thought, 'Maybe that will change the picture.' Maybe it will, but, on the other hand, these numbers jump around a lot from month to month. That zero followed a very big rise last month of 0.7 per cent, which is quite a big rise in a month. If you average out the rise in the CPI in the US over the last three months, it is running at a monthly rate of 0.3 per cent or an annual rate of 3.6 per cent, which is a fair bit higher than the 12 months annual rate, which is about two per cent. So there is some evidence that US inflation is going up a bit.

But I think the more important thing for the US is this medium-term need to reverse the temporary measures that were taken in the second half of last year. Of course, when I say that, when I explain what has happened in the US, both in terms of that and in terms of the actual inflation numbers, you can see that we are not really in that position here, even though we have a growth rate which is in fact higher than that of the US. As I said in my introduction, we do not, at this stage, judge the Australian economy to be subject to any significant wage and price pressures. So we would see ourselves, domestically, as being in a very different position from the US.

CHAIR—Can I just clarify that point? What you are saying is that there is obviously a big market expectation that the US will increase, and you say they have factored in that expectation of an increase. If it does come forward, are you saying that you will not feel the same pressure for Australia to do something similar?

Mr Macfarlane—Monetary policy in Australia is made primarily in relation to domestic considerations. Our inflation targeting regime, which we are still very confident in and we are still very happy with, says that the Australian monetary policy is principally adjusted in response to what our inflation target says. If our inflation forecast has us at or in the band, then there is not prima facie a case for an adjustment to Australian monetary policy.

Mr WILTON—Mr Macfarlane, in relation to the impact of the fiscal stimulus emanating from the tax package on monetary policy, the government is about to pump the economy with some $12 billion worth of tax cuts equivalent to a fiscal stimulus of about one per cent of GDP. That is coming at a time when imports are way ahead of exports, national savings are fairly stagnant and we are still growing faster than our trading partners. Is that sort of stimulus appropriate right now? Would you agree with Treasury Secretary Evans when he said before a Senate estimates committee the other week that, effectively, if growth in that stimulus boosted inflation, there would be a need to raise rates? What level of growth might cause a problem in that regard?

Mr Macfarlane—There are about three questions tied up in that one question, so I will try to methodically work my way through them. The first one is really a question of forecasting what state the economy is likely to be in in the middle of the year 2000. As I indicated in my introduction, we are assuming in our forecasts that the economy will be growing a good deal more slowly than it is now. It will have slowed. It is still in the

expansion phase. It is not going to be contracting, but it will have slowed. We think, and I think virtually all the private forecasters have the same view, that because of the outlook for investment and because the behaviour of consumption this year was somewhat exceptional by growing so much faster than disposable income—but that will not keep up next year, so the growth in consumption will return to something a little more normal, that is, in line with household disposable income—the economy will slow from the sorts of growth rates it has been achieving now to something more like three per cent.

The conventional view, which I share, is that the Australian economy will slow next year. Similarly, the conventional view on the world economy is exactly the opposite. The conventional view there, which you can see in the forecasts of the OECD, the IMF and the private forecasters and even more clearly in the behaviour of interest rates—the rise in interest rates through the first part of this year—in the rise in some important commodity prices like oil and in the rise in the prices of resource stocks, is that 1997 and 1998 were bad years (it was really the second of half 1997, and 1998 and 1999) but that by the time we come to 2000 the world economy will be growing a fair bit faster, not because of the US, because the US is expected to slow down, but because Europe now seems to be picking up. We have finally got some good news from Germany, which is the biggest European economy. East Asia has picked up, particularly Korea; it has been quite extraordinary. There is even a possibility that Japan will pick up. As you are aware, Japan had a very good first quarter GDP number. But Japan does not actually have to pick up and run away for it to exert a favourable impact on the world economy. All it has to do is stop declining, which I think it will.

So the general picture that all our policies at the moment are predicated on is a slower Australian economy next year and a stronger world economy. They are only forecasts, but they are not some eccentric forecasts which are totally against everyone else's expectations. They are the general assumptions that most people are working on at the moment. If that happens, I think we are in a very good position to handle policy changes next year.

I now want to talk specifically about the monetary policy implications of a GST. I have already said, I think, to this committee last time I was asked that the textbook—and I agree with the textbook on this—says that a change to sales taxes in any form (and I would include a GST within that) has a once and for all effect on the price level. It moves it up as those prices are adjusted upwards.

Monetary policy has to accept it; monetary policy does not try to resist it. Monetary policy allows it to happen, and it then gets on with the normal business of making sure it does not become continuous inflation. So the price level goes up. During that period the measured rate of inflation goes up, and then the measured rate of inflation returns to what it was before. That is the way we would be handling it. What that means is that a GST per se has no implication for monetary policy.

The next issues you raised were: what if a GST has attached to it a very generous compensation package which involves a fiscal expansion? Does the compensation package—which is not intrinsic to a GST, but it just happens to be attached to the GST in Australia at the moment—have an implication? My answer is that, on the basis of our current forecasts, it does not. On the basis of our current forecasts, the economy would be in the position

where it could comfortably accommodate a fiscal expansion. In fact, at one stage, when we were a little more pessimistic in our view of the output growth of the Australian economy, some of my colleagues were saying that it would be a nice idea if they could bring it forward and bring the fiscal expansion forward. I do not think that is the case now but, if the economy does slow to those sorts of growth rates that I am talking about, fiscal expansion would not cause a problem.

Ms BURKE—How do you forecast what the price effects of the GST will be?

Mr Macfarlane—We do not make an independent forecast of the price effects of the GST. It is a very complex issue because you have a whole lot of individual prices going down as the wholesale sales tax is taken off individual items, and you have a whole lot of other things going up. You really need a very disaggregated forecasting model to do that, which we do not have—you do not build one of these things and use it only once, whereas it is an ongoing part of Treasury's work—so we would essentially be relying on the Treasury forecast. That does not mean that we would totally accept it at face value; we would interrogate them and we would ask what would happen if this assumption were different or that assumption were different. But essentially we do not have an alternative forecast of the once-off price level effect—inflation is the wrong word—of the introduction of a GST.

CHAIR—Can we go back to one of the assumptions in the earlier part of your answer to Mr Wilton. You were talking about the expectation of improvements in Europe in particular and possibly in Japan. I draw your attention to the announcements yesterday or the day before by ABARE on commodity prices and the value of commodity exports. That seems to be a bit contradictory, doesn't it?

Mr Macfarlane—The ABARE forecast for the world outlook is very similar to the one that I gave. ABARE does it in terms of financial years. I think they had 2.2 per cent growth in the world economy for 1998-99 and 2.9 per cent for 1999-2000, which is nearly three per cent—which is roughly the figure that was used by the OECD and the IMF. So, in terms of the growth of the world economy, the ABARE assumptions are very much the same as the OECD-IMF ones.

As for particular Australian commodity prices, it is a bit more difficult. Australian commodity prices are a little out of sync with the rest of the world, and one of the reasons we are out of sync is that our biggest commodity prices are coal and iron ore. They are not determined in spot markets; they are basically contracts that are written for a year. So we had this once-off fall in those very important commodity prices in April, which had a big impact, for example, on our commodity price index. But, at that time, prices for various raw materials, food and resources on various spot markets around the world were going up. If you look at the spot markets or the main daily price indices, they have been going up, and that is why the prices of Australian resource stocks have been going up. So our recorded commodity prices do not have this one-for-one relationship with the strength of the world economy. That would be an explanation for why in Australia our aggregate commodity prices lag the pick-up in the world economy.

CHAIR—I was talking more about the value of commodities. According to this report, the value of commodity exports is estimated to reach $63.1 billion next financial year—a fall of $3.9 billion since 1997-98.

Mr Macfarlane—If the price goes down, the value goes down. Can you add something to that, Glenn?

Mr Stevens—The story here is that, in the ABARE forecast for export values, you have the full-year effects of price falls which have already happened. The price falls for the big commodities, as Ian said, happened in April, so they do not have much impact on 1998-99. The big year average impact is in 1999-2000, so our thinking about commodity export values is not that different from the sorts of numbers that ABARE put out. I do not really think there is all that much news in them. The news was the big cuts in commodity prices in bulk coal and iron ore, and that actually happened at Christmas, announced to take effect from April. So that was the news back then.

CHAIR—The purpose of the question was not so much about that. We were talking about economic activity in other countries picking up; therefore that would benefit Australia and therefore compensate for some of the downturn in other areas. I am wondering how you tie that in with the fall in the value of commodity exports.

Mr Macfarlane—If the world economy does pick up, it will benefit us. We will benefit immediately from all the commodities whose prices are determined in spot markets. With those ones where you have annual contracts, we will benefit with the lag of one year. Just as it is lagging behind this year, it will lag behind next year. So it is really a timing factor.

Mr ALBANESE—To follow on from Ms Burke's question about the GST and inflationary impact, you stated that the Reserve Bank is not in the position of making an independent assessment—and I accept that in terms of inflationary forecasts—but you also said that you would be looking at what the Treasury estimates were. Have you done that up to this point, and do you agree with the 1.9 per cent figure which they have given?

Mr Macfarlane—This is a very technical matter, so I will hand over to my technical expert.

Mr Stevens—The answer is that we have had some discussions on this with the relevant Treasury people so we can understand their modelling and their methodology and how they have arrived at that 1.9 per cent cost-of-living figure, which will probably be lower now with the changes to the package anyway. I think the methodology is fine. All these things are subject to the nature of the model you have and the assumptions you make, but I think what they have done is perfectly reasonable, so that number I think is fine.

Mr LATHAM—What about the 2.8 in year one?

Mr Stevens—It is well known that the short-run impact is bigger than the long-run impact. The 1.9 is a long-run impact. If you are thinking about compensation and so on that is forever, then obviously that is the right number to focus on. But it is certainly true that the short-run impact will be bigger than the long-run impact because the passing through of cuts

in sales taxes and so on—where prices come down—will take a while. I think the Treasury quoted a number of 3.1 in some parliamentary hearings. That is year-one figure and the 1.9 is a much later number.

Dr SOUTHCOTT—I would like to explore some of the components of aggregate demand that we are seeing at the moment. Consumer spending is very strong. We have seen business investment decline over the last four quarters, and housing investment is flat. I notice in your *Semi-Annual Statement on Monetary Policy* that you are confident that this is just a blip in business investment, but how do you reconcile the two when you are looking at the setting of monetary policy—if we are to continue to have growth driven by strong consumer spending and declining investment?

Mr Macfarlane—I think you have to look at these things over a whole expansion, rather than just a particular year. In any particular year, you can have something much stronger than its trend and something else much weaker than its trend. At the moment, you are right; we are in a situation where consumption is stronger than its trend and investment is weaker than its trend.

If you look over the expansion, it is not that way at all. If you look over the whole expansion which has been going on since 1991, the figures are that investment has grown at nine or 10 per cent per annum and consumption has grown at about 3½ per cent per annum. So, it has actually been very healthy over the whole expansion. But within that you can find individual years where investment is weak or consumption is strong, and I think that is what we are seeing at the moment.

In fact, we are taking it at face value. We are assuming that it is going to happen, that we are going to have a flat spot in investment for a while. But that is minor compared with the medium term performance we have had, where investment has grown very strongly.

There is always in the back of my mind the worry that the figures are wrong as well. I have to say that there have been at least two or three occasions in the last 15 years when investment has appeared to be extremely weak and then, when the numbers have been revised, it has turned out to be a lot stronger than the initial figures suggested. We are not second guessing the numbers this time. We just let you know that that has happened. We are taking them at face value.

The other thing that you must remember when you are doing economic forecasts is that the conventional way to do it is always to go down the expenditure side of the national accounts and see what has happened to consumption, what has happened to government spending, what has happened to house building, what has happened to other investment, and what has happened to stocks, exports and imports. You go through all these individual items and come to a GDP at the bottom.

But that is only one way of doing it. It happens to be the conventional way, and I think that way of doing things is getting a bit dated. Sometimes you might do better just looking at the income side, and what has happened to wages, what has happened to profits and what has happened to employment over the last year, and say, 'Is there any reason why this

momentum is going to fall in a heap?' If you do it that way, you would get a lot closer to the right answer over the last few years if you had done it from the income side.

Basically, business is very profitable; business can borrow very cheaply, business can raise equity very cheaply and business has a lot of retained earnings. There is no reason in the medium term to think that business is going to decide that it cannot afford to invest. It is just that in the year-to-year numbers they go up and down.

Dr SOUTHCOTT—Based on that you are happy that they are not sending contradictory signals for monetary policy setting?

Mr Macfarlane—I am confident of the medium term business investment. The things that matter to me more than what the actual CAPEX numbers say—if I am looking out three or four years—are the things that I mentioned, the financial state of the corporate sector. Can it borrow cheaply? Can it get equity cheaply? Has it got a lot of retained earnings? Is business confidence high? Those sorts of matters are more the fundamentals, and I think the fundamentals are still reasonably sound.

But I am not surprise that, after having done so much investment over the last eight years, there is a bit of a pause. If my whole job and life was making annual forecasts, I would regard that as a very important fact. But, if I see my job as trying to keep a sustainable expansion going, I am not particularly worried by those sorts of numbers.

CHAIR—On that point, you are talking about business confidence and expectation. One of the things that you pointed out earlier in your comments that has been driving the growth is the level of consumer spending, but at the same time the level of household savings has hit an all-time low—according to you—since you have been measuring it. Wouldn't that suggest that household spending cannot continue at the present rate, because it must run out of steam sooner or later? Therefore, isn't that going to have a dampening effect?

Mr Macfarlane—Yes, indeed. On the expenditure side of the national accounts, they are the two things that explain why we expect this slowdown from this 4¾per cent per annum that we have had for two years slowing down into the threes. They are the two main factors. Firstly, there is what I believe will be a temporary pause in investment and, secondly, I would be very surprised if households can continue to spend so much faster than the rise in their income. It is not out of the question that they will continue to do that, but I am assuming that they do not. I would think that that would be a moderately good thing. Even if it causes the growth rate of the economy to slow down, you have to expect that you are going to grow less than average half the time.

Mr WILTON—Do you have any evidence, for example, that households may be borrowing on the back of wealth generated by capital gains in equities and are now borrowing to invest in equities? What has been the growth in that area of activity and how well equipped is the finance sector to monitor it?

Mr Macfarlane—Yes. We have put out a piece recently which has some information on that. It is clear that some of that very big increase in consumption over the last year has been generated by temporary effects. The demutualisation of the AMP Society particularly,

and the very big increase in prices of some of the privatised shares, have given people a once-off windfall. You could say, 'Aren't you worried that that is only a once-off and it will go away?' As I said, I am not particularly worried about that. I would be more worried if they continued to increase at that rate.

It has actually been fortuitous in a way. This is a time when we really needed a bit of domestic demand, because we had this contraction internationally that we were facing. We were going through a very difficult period. It has been fortuitous and helpful that we have got a bit of an increase in domestic demand coming from these once-off factors. That is certainly true. It is also true that there has been much greater use of marginal lending than we thought with people borrowing to buy shares. I do not think it is anywhere near the scale of the US, but when we looked into it, it surprised us that it has been a strong as it has.

Mr LATHAM—On this question of household spending and household debts, in the semiannual statement it says:

Nevertheless, a continued period of rapid growth in household credit could generate concern . . .

What is the exact nature of your concern and what implications would it have for a monetary policy response? It is on page 18 just above the graph on household debt and interest.

Mr Macfarlane—Yes. I do not think you could justify a change of monetary policy simply on the grounds that households are taking on more debt. In fact, we have not used that. As you are aware from these things, households have taken on a lot more debt over this expansion. It has moved from about 40 per cent of household debt to income. It has moved from about 40 per cent up to about 90 per cent and that is quite a big move. It is not all that big when you look internationally. The level is not high internationally, but the move has been quite big.

We do not have a moralistic approach to monetary policy. We cannot say to people, 'Look, you are doing the wrong thing. You are borrowing too much money. We are going to tighten monetary policy.' We cannot target monetary policy to individual borrowing patterns. We cannot get up in the pulpit and say to them, 'Neither a lender nor a borrower be. You have done the wrong thing.'

The only way that it enters into the monetary policy equation is if it leads to very rapid growth of consumption at a time when the economy is already growing very quickly and where it is approaching its capacity limits and, therefore, it would threaten to drive inflation up. In that case, that particular category of domestic demand—and it may not be the only one; it may well be that investment is growing too fast at the time, or a number of other things are growing too fast—will contribute to an aggregate excessive domestic demand which would have an inflationary implication. In that hypothetical case, it would then generate a monetary policy response. What I am getting at, Mark, is that I do not think you can use monetary policy to discipline the household sector into maintaining some particular borrowing to asset ratio or borrowing to income ratio.

Mr LATHAM—But on the related issue, haven't you flagged a change in policy attitudes earlier today and also in an article two days ago from the bank? You said that the

main implication of this sensitivity to household budgets and interest rates is that interest rates would not have to be raised as much as formerly was the case to have the same impact on economic activity? Is that in contradiction of the policy that the bank had earlier this decade which was about big licks, announcement effects and having a pretty solid movement in rates at any one time? If it is a change, as you have indicated, can you quantify what we are talking about? Instead of 50 basis points, do you now talk about 25?

Mr Macfarlane—The history of this is that we started this decade with cash rates of 18 per cent. If you wanted to get those down within any reasonable time period, it made sense to move in by what are by international standards very big movements—a one percentage point change is, these days, a very big movement—so we moved in one percentage point changes and we made announcements at the same time, which was novel at that time. As the rate of inflation has come down—and we have now got rates of inflation around two per cent—it clearly does not make sense to move in a big unit like one per cent, so we have moved them down, and most of the recent moves were half a per cent, and of course the most recent one was 25 basis points, a quarter of a per cent. I think that the reduction in the size of those movements is mainly just a result of the lower rate of inflation.

The issue that I think you are referring to is that, if you went through a phase where interest rates went up—and at some stage we are going to have to; interest rates do go up as well as go down and at some stage we are going to go through a phase where they are going to go up—how far would they have to rise from trough to peak? That may involve more than one movement and that is what I was referring to, in that the rise from trough to peak would not have to be as high.

If you remember back to 1994 when interest rates went up, a lot of people thought they were going to have to go to 10 per cent or something—people had that in their minds—because they could still remember the very high interest rates of the 1980s. In the event of course they did not; they went to 7½ per cent. The rise from peak to trough in the 1994 period was 2¾per cent, which was much lower than anyone expected. All I am saying is that it is quite possible that whenever the next episode occurs it could be lower again—I don't know; it could be—because certainly the household sector would probably be more sensitive.

Mr LATHAM—You were talking in the article two days ago about a given rise in interest rates; it was not trough to peak. To give the quote: 'Accordingly, the impact on economic activity for a given rise in interest rates may be larger than in the past.' You were therefore inferring that the given rise does not have to be as big as past policy settings.

Mr Macfarlane—You do not have to have as many given rises. So the peak to trough would not be as high.

Ms BURKE—I take your point that you cannot tell people where or how to put their money, but is there any concern about the growing rate of mum and dad investors? That seems to be something that the market plays up as a great thing—where they are actually putting their money, what risks they are taking and what information they are giving.

I am going to chuck in a second question, which is totally unrelated to that, so that I do not get lost in the flow. It is about employment. Even though we have had the miracle

economy, good growth and huge consumption spending, we have not had a matching rise in employment to correlate to that productivity growth. Do you think we are at full employment? In what sort of sense in monetary policy are you worried about employment issues?

Mr Macfarlane—You are certainly right there: they are two unrelated questions.

Ms BURKE—Totally, but I just thought I would do them now.

Mr ALBANESE—She's on the end.

Ms BURKE—I'm at the end—I can't see the chairman.

Mr Macfarlane—As for the first one, I am not going to spend much time on answering that because I am not really sure what the answer is. From my perspective, and from the perspective of the Reserve Bank, given our charter, it is really not our job to worry about people making unwise individual investments. I suspect that is really more in the charter of ASIC—making sure they are well informed, they are not being duped and all the rest of it. If they are utterly well informed and they are still doing something which is stupid, dangerous or excessively risky, I do not know what you would do about that. I do not really think I can say much more about that one.

The second one is an interesting one, and there is a short-run answer and a long-run answer to it. The short-run answer is: yes, we have been a little surprised that the rise in employment over the last three or four months has not been higher. It seems to us it should be higher, given what has happened to GDP growth, given what has happened to things like vacancies, which are at very high levels—levels that are usually consistent with much greater growth in employment—given the answers that you get to surveys when you ask businesses what their hiring intentions are. All that sort of data suggests that we should have been seeing higher employment growth over the last three or four months. We are still expecting to see it. We think it is just a bump in the series—all economic data is very lumpy—and this has happened a number of times before. We are a little bit surprised, but we think it will come through.

I come to the longer term issue, having had this nice expansion or while still being in this nice expansion, of: why is unemployment higher than we would like it to be? This is often viewed by comparing us with the United States, and it is quite clear that the United States level of unemployment is lower than ours. But the interesting thing is that we have actually brought our unemployment rate down more than the US has, at the same length of expansion roughly—ours is only a quarter less—so we have made the same progress. The problem is we just started from a much higher base. All the damage with unemployment was really done between about 1973 and 1983; we went from a low unemployment country to a high unemployment country. It takes a long time to get it down again. We are making progress. As I say, the rate of progress is actually as you would expect, because we have slightly faster growth. We are making slightly more progress than the US. Our starting point was just that much worse.

Mr WILTON—Would there be any public benefit from further cuts to the cash rate?

Mr Macfarlane—My answer to this question is the one I always give: the best thing that can happen to unemployment is to have a long, sustained expansion. That is how you make the progress. As I say, we have been making progress. It does not benefit from just trying to speed up the growth this year. In the short run, a speed up in growth might give you some short-term gain but, if you are taking a risk in doing it, it would be very unwise for the long-run future of employment. I think the way we are playing it now is the right way.

CHAIR—Mr Macfarlane, can I follow up the previous answer. You are obviously quite optimistic about employment growth. Would you be able to give some indication of what level of growth you are talking about when you say that you think it is going to improve?

Mr Macfarlane—Employment tends to lag a bit behind growth. What we are saying is that, with the growth we have had over the last 12 months, some of that 4¾ per cent—or whatever it is—should still be coming through and employment should be growing fast enough to reduce unemployment. We think the unemployment rate should go down further.

CHAIR—Would you care to hazard a guess?

Mr Macfarlane—Do you have a forecast there, Glenn?

Mr Stevens—Until recently the annual rate of employment growth was running in the low twos—a bit over two per cent. With the weakness in the last few months' figures, that has come down to about 1¾ and, as Ian says, that number to us seems lower than it should be. I would expect a bit more than two per cent in employment growth to resume in the period immediately ahead, and that will be enough to just edge the unemployment rate down some more over the rest of this year. That is basically the forecast that underlies the numbers that Ian gave at the beginning.

CHAIR—So you would not actually give a ballpark figure of where you would see the unemployment rate coming down to?

Mr Stevens—A bit further below seven, seven per cent—something like that—at the end of this calendar year. Beyond that it is going to depend on just how much of a slowing in the economy occurs and how long that lasts.

Dr SOUTHCOTT—You touched on this in your opening remarks. There used to be a view that the Australian economy could sustain an average growth rate of only about three to 3.25 per cent. Over the last year it grew at 4.8 per cent with evidence of excess capacity and no real inflationary pressure. Some people have been talking about a step-up in labour productivity which has led to an increase in the average rate of growth of probably about four per cent. Does the Reserve Bank ascribe to that, that the speed limit on Australian growth has increased?

Mr Macfarlane—The evidence that has come in on increase in productivity must, other things being equal, mean that we can now sustain a higher growth rate than formerly. People will then immediately ask, 'What is the number?' My answer to that is that I do not know what the number is but the approach we adopt to monetary policy will achieve the number, whatever it is, because you let the economy grow until you see an inflation threat and when

your inflation forecasts go up, you try to slow it down. If it wants to grow faster than you thought but does not actually cause any more inflation, you simply let it grow faster. That is basically what has happened over the last three years or so.

When I first came into this job, I can remember a lot of people said, ‘The Reserve Bank has a ceiling on growth; it is 3½ per cent. The Australian economy is not allowed to grow more than 3½ per cent per annum.’ My defence was, ‘No, we don’t have a ceiling. Whatever the sustainable rate of growth is, it will emerge from our process of monetary policy formulation.’ At that stage, I had no idea that the economy was going to grow by 4¾ per cent per annum in the following two years. That is an example of the process in action. We did not say, ‘Gee, the growth numbers look higher. Let’s tighten.’ We said, ‘The growth numbers look higher. Is that something to worry about, or not? Let’s look at the inflation forecast. It is nothing to worry about.’ You accommodate the higher growth.

Mr ALBANESE—Still on the issue of growth, your US counterpart, Alan Greenspan, has indicated that investment in new technology is a major factor in boosting US productivity. Do you think that here there is enough investment in new technology and research and development? What do you think the implications for growth in investment in technology are here? How important a role does investment play in core infrastructure, particularly from the public sector, in improving productivity?

Mr Macfarlane—Part of the productivity story in Australia would clearly be the use of new technology. You can think of all sorts of examples where a lot more is produced with a smaller number of people and a smaller amount of capital in some cases because of newer techniques for doing things. Part of our improvement in productivity is because of the use of new technology. As markets become more and more competitive, firms have had to rush to bring in new technology. That certainly is the case. The next part of your question is: if that is a good thing, why don’t we have more of it, and should the government do something about getting more use of technology?

Mr ALBANESE—Absolutely.

Mr Macfarlane—I am not sure whether I would agree with that. There are some very respectable arguments for why there should be heavy government involvement in subsidising things like research and education—because the returns do not necessarily all get captured by whoever did the clever piece of research. There are very strong arguments for doing that, but I would be sceptical about government involvement in encouraging firms to use a particular new sort of technology. I would have thought a competitive environment and, of course, a good education system and all that goes with it would be enough to make sure that firms use the most efficient technology.

Mr ALBANESE—I guess a complementary question is: do you have any comments about the amount of concern about the failure of Australia to attract venture capital?

Mr Macfarlane—Yes. We do not seem to have the same culture of wealthy people putting large sums of money into risky ventures that the Americans have. It seems to me that this is almost unique to America, although we do have some examples. Historically, in Australia, we have never had trouble attracting venture capital into mining. There is a history

of Australians being quite prepared to take a punt on mining companies. I am not sure why we have not had the same success in getting people to take a punt on small manufacturing or service companies, although I think it is starting to happen. Some of these very small service companies in the computing industry seem to be not having very much difficulty at all in raising equity finance.

Mr ALBANESE—Surely the relative sizes of the domestic markets are one of the factors. Isn't there an argument that Australian government policy needs to be more geared towards attracting that venture capital because of the relative size of the domestic markets? In Australia if we are going to compete with the US economy in attracting venture capital there is an argument that there is a need for government to have policies geared towards something more interventionist, something that makes it more attractive.

Mr Macfarlane—I am not sure that the size of market is a convincing argument there, because we need less. We are smaller but we need less than the US. When it comes to a role for government, I think the nature of venture capital is that these things are so difficult to pick and the probability of each one succeeding is relatively low but if it does succeed there is a high pay-off. It is the sort of allocation of capital where you need lots of decentralised decisions. I do not think you could have a central bureaucracy that would have any success at all in doing that.

Mr ALBANESE—The tax policy is the factor—

Mr Macfarlane—I think you are asking whether there is a case for a tax regime that encourages venture capital—like the old managed investment scheme that was operating in the 1980s—where you give very generous tax deductions. I am not sure that I am really qualified to answer that. In principle, it sounds like a very good idea; in practice, I think the problem is how you stop the money that is going to get this tax preferment which is supposed to go into really terribly risky things from also going into plain vanilla investments that really did not need all that tax preferment. I think it is really a technical issue for the tax experts to resolve, although in principle if you could design a perfect system there may be a very good case.

Dr SOUTHCOTT—I want to ask you about import prices, which we have spoken about at previous meetings. Previously it was evident that due to the devaluation of the Australian dollar we were seeing that import prices as expected across the dock had risen 10 to 13 per cent or so. But that has been passed on in consumer prices; we have actually seen a drop in the prices of imports, which is contrary to expectations. There has been a bit of speculation that that may not be maintained—that importers' margins have been squeezed due to great competition. What are your forecasts for import prices?

Mr Macfarlane—You are right. This is a very big question and it has caused a lot of people to spend a lot of time agonising over it. Glenn has probably spent more time than most agonising over this one, so I will let him see if he can handle that.

Mr Stevens—It is certainly true that the measure of import prices we have for the consumer—in many ways it is not that great a measure, and ABS would be the first to argue that, but it is the only one we have—has behaved quite differently from its historical

relationship with the measured import prices at the docks and quite differently from what we expected. That is the principal reason that the rise in inflation so far has been a little less than we anticipated.

All along we have tended to take the view that the implied extent of margin squeeze surely cannot persist indefinitely, that at some point something has to give and these prices have to rise; either that or eventually the exchange rate goes up and rescues their margins that way. So we have maintained the idea in our forecasts that there will be some pass through of this effect, but less than historical average and obviously more delayed. That idea underlies under the forecast of inflation returning to about two per cent over the year to December this year.

One example of these quite remarkable forces at work is the price of cars, which we put in a little box in the statement. There is quite a dramatic reduction in the price of cars compared to that seen in other countries. That has taken about half a percentage point off the underlying inflation rate per year for the last three years. If that just stops happening, obviously the measured inflation rate will drift up a bit. That kind of thing underlies our general outlook. We have come to the view that the old historic relationships will not fully reassert themselves, otherwise there would be a bigger rise in inflation than we currently forecast.

CHAIR—On the question of inflation forecasts, for eight quarters now you have come in below target. Are you happy to try to continue to do that, or do you feel that in the long run there will be a downside to that?

Mr Macfarlane—We are not trying to do that. We were not even trying to do it for those eight quarters. Basically, we set policy on the basis of our inflation forecast, which was that inflation was going to be two or 2½ per cent, or whatever it was, and we are genuinely surprised by the fact that it has come in lower. As Glenn said, one of the biggest contributors has simply been the fall in car prices, which you would not have picked given the fact that the exchange rates of some of the countries that export to us have fallen. You would think that it would not have happened to the same extent. Let us put it the other way: that we have depreciated against, for example, Europe, which is the source of a lot of cars.

The general answer to it is that bygones are bygones. The fact that you were under it for eight quarters does not mean we should say, 'Let's try to get over it for eight quarters.' You always have the thing that is guiding you pointed at the target. So if your inflation forecast is at the target, you say that monetary policy is right.

CHAIR—You do not see any value in revising your target?

Mr Macfarlane—No, I do not see any value at the moment. It seems to us that some of the factors which caused the undershoot were temporary, for example, falling car prices. If this happened year after year, then maybe you would have to revise the target.

Mr WILTON—Governor, you said both in December and again today that a one-off lift in prices post-GST should not get built into underlying inflation and simultaneously be factored into future union wage claims. If you do accept that when bracket creep is taken

into account the tax package is unfair, why should not the price effects of a GST be an important consideration in future wage claims?

Mr Macfarlane—That is a very technical question you are asking me. I have to say I thought the compensation would take account of that and that there was not a need for wages to claw some of the rise in the price level back as it was fully taken into account in the reductions in income tax. That was my understanding. That is what I am assuming.

Mr LATHAM—On the GST, you say you are looking through direct impacts. What about the indirect ones, such as an increase in inflationary expectations by virtue of this supposedly temporary increase in underlying and headline inflation rates?

Mr Macfarlane—We would certainly follow them. Inflationary expectations are an important component of an inflation forecast. At the moment the household inflation expectations—according to the main survey that is used, the Melbourne Institute survey—have actually never come down to the two per cent; they are still three per cent plus. In fact, there has been, if anything, a little tendency for them to rise over the last six months, which a lot of observers think is already a build-in of the GST into the inflationary expectations. So they may already have gone up partly as a result of the expectation of a GST.

My only answer is that, as I said, inflationary expectations are one component of an inflation forecast but not the only one. It is quite possible that you could have inflationary expectations go up—as they have over the last six months—without inflation itself going up. There are a whole lot of other measures that you have to look at. The experience of New Zealand, Canada and other countries, which have had not necessarily the introduction of a GST but an increase in a GST rate, is that it has been a once and for all lift and has not followed through into a higher rate of inflation.

Mr LATHAM—But you are factoring into your thinking an increase in inflationary expectations, and we are already seeing the evidence of that.

Mr Macfarlane—Some of which has already occurred, yes. I do not think you could sterilise it completely. I do not think you could get people to be totally unaffected by a once-off rise in the price level, but I do not think it necessarily follows that it will lead to ongoing inflation.

Mr LATHAM—I want to come back to the question of the current account deficit, which not only seems to be a topical matter but also the subject of some historical analysis by the bank. I noted the speech by the Governor in March where it was stated that the previous assumption that a current account deficit above six per cent of GDP was unsustainable—and that was the orthodoxy in the eighties—might not have been totally accurate. You have stated here that it is now the bank's view that the situation was not unsustainable. With the benefit of hindsight, what would have been the point of unsustainability in the eighties if not six, seven or eight per cent?

Mr Macfarlane—I do not know the answer to that, but my little bit of historical analysis there is clearly correct. If something has been sustained, it must have been sustainable, and that is really all I am pointing out. In the mid-eighties—and I used some graphs to

demonstrate this—if you had only the information that was available up to the mid-eighties, you saw a line on 'Debt to GDP' which seemed to be shooting up at 45 degrees and you also had a line on 'Debt servicing as a ratio of exports' which was also shooting up at 45 degrees. I think that people did not have the rest of the graph at their disposal then and that is why I think a lot of people thought it was unsustainable. Now we go back, add the rest of the graph on and we see that the debt to GDP ratio basically flattened out at about 40 per cent, give or take a little bit, and has been at that for a decade or so.

Perhaps even more decisively, the debt service ratio, which is debt payments as a proportion of exports, and which reached a peak of 20 per cent in the late eighties, has come down and is about 10 per cent. It has been around 10 per cent for most of the last decade. This was the only point I was trying to make: if you only had the information available up to 1985, it was not unreasonable for you to think that the thing was going to be unsustainable—it looked frightening—but, now that you have the data available for a further 15 years, you can see that perhaps we should not have been so frightened.

Mr LATHAM—Are you confident markets factor in those two or three statistics in their judgment about sustainability?

Mr Macfarlane—I am not confident as to the extent to which they factor them in. Clearly they factor them in to some extent, otherwise they would have been more nervous than they are at the moment. As you are probably aware, I have been saying since March last year that I thought the current account was going to reach six per cent of GDP. So far I have been wrong, but I still think it will. Maybe it has caused a little bit of caution on the part of some people but it has not caused the sorts of reactions that a statement like that would have made if I had made that statement in 1985 or 1988.

Mr LATHAM—To move to the future, have you a forecast for the current account deficit for the year 2000?

Mr Macfarlane—I think in my introduction I mentioned a figure for the next financial year of about six. I think it will come down after that. After the next calendar year I think it will start to come down because the overall picture of the world economy that underlies all of our analysis at the moment is of a stronger world economy in the year 2000 and a weaker Australian economy. So I think that, even though it will rise to those sorts of numbers, it will come down.

Mr LATHAM—In explaining the current account deficit, the government has pointed a lot to East Asia. Have you any estimate of what the current account deficit would be if there had been no disruption of our trading partners?

Mr Macfarlane—No, I am sorry I cannot give an answer to that other than that it would be a smaller current account deficit. If our markets had not contracted as much as they have, it would be smaller.

Mr LATHAM—How do you see the current account deficit now? We have what has been labelled the 'consenting adults defence': that because government budgets are in a savings position these are free investment and savings decisions of the private sector rather

than the public sector and that seems to make market reactions more benign to the growing size of our current account deficit. Can you elaborate on this defence? And can you perhaps also point out what sorts of parameters might cause a problem and a loss of market judgment on sustainability, even though it is between adults rather than governments?

Mr Macfarlane—That view has been around for quite a while. In Australia it is usually associated with Professor Pitchford, although I believe Professor Cordon reached that view somewhat earlier. In the international arena that is usually referred to as the 'Lawson argument' after Nigel Lawson, who was Chancellor of the Exchequer. I have not actually used that one in its direct form. I have used a different argument which is a bit broader than that.

It is that, if you have a current account deficit and it appears to be the result of domestic policy imbalances, that is more worrying than if you have a current account deficit which is principally the result of the fact that there is a temporary slowdown in your trading partners—and I think that is true. When we had a current account deficit of six per cent of GDP and it coincided with a significant budget deficit and a period when our inflation was higher than that of our trading partners, that was more worrying than the sort of current account deficit we have at the moment. It is not related to government dis-saving and is not related to a higher inflation in Australia than in our trading partners. But it is principally due to the fact that we have been able to grow at a good rate, whereas a significant number of our trading partners have not only not grown very fast but have positively contracted. So I think it is a more benign current account deficit now than the sorts of current account deficits we had before.

Mr LATHAM—On the current account, at the estimates committee two weeks ago the secretary to the Department of the Treasury, while talking about economic growth, said that, if it were growing strongly enough to be heralding a problem on the current account you would have to see a fiscal policy response. So, even though this is something that is benignly happening in the private sector, the head of Treasury was saying you would need a government fiscal policy response. Are you worried that the government is eating up too much of its budget surplus with its GST package? Are you also worried, if this does require a fiscal policy response, that fiscal policy has been locked in so far ahead with the arrangements and the stimulus in July next year?

Mr Macfarlane—I do not know exactly the question that Ted Evans received or what his response was but I think one of the main things he was trying to put was the general view that if the balance of payments were to become a problem—and I do not know what 'becoming a problem' means—then the normal response to a structural balance of payments problem would be on the fiscal side rather than on the monetary side, and I agree with that.

As to the other issue of whether it is going to become a problem, our forecast suggests it is not going to become a problem. Our forecast suggests that the current account will reach a peak of about six point something per cent of GDP and then it will come down. So I would not regard that as being a problem, and I am not absolutely clear what a problem is. If it becomes so high that it is difficult to finance, in a fixed exchange rate world that becomes a huge problem; in a floating exchange rate world it is not as big a problem. But our central

projection at the moment is that the current account will peak at six point something per cent of GDP and then come down as the world economy picks up.

Mr LATHAM—I suppose the problem can be defined through the eyes of the market. There was a time when Thailand thought they did not have a problem but the markets gave them a problem. What sort of risk do you think we are exposed to? If it is not in black or white a problem or not a problem, how do we define it in terms of risk?

Mr Macfarlane—Thailand had a fixed exchange rate. I have no doubt that if you have a fixed exchange rate a current account deficit can become a very big problem, because you have to finance it and if you cannot finance it you have to give up your exchange rate regime. Giving up a fixed exchange rate regime under pressure is always a nasty business and always involves all sorts of problems. There was serious capital flight and it caused a huge problem. In our economy with a floating exchange rate I think that sort of crisis is not likely at all.

Proceedings suspended from 11.36 a.m. to 11.49 a.m.

CHAIR—In your May statement you made these comments:

> In the light of the greater stability in the market and the higher average level of the exchange rate, the Bank in mid April resumed its normal practice of covering the Government's foreign exchange needs by purchasing foreign currencies in the market. In the period since mid 1997, the Bank had met these needs directly from its foreign currency reserves.

That raises the question: why did the bank feel the need to limit the downward pressure on the Australian dollar by using foreign currency reserves?

Mr Macfarlane—This is a rather technical question because we would not classify what we were doing as being foreign exchange intervention. In the normal course of events, when the government wants to spend money abroad, for example, for defence procurements or embassies and so on—and they spend about $3 billion or $4 billion abroad—it buys that foreign currency from the Reserve Bank, which is a very sensible system and we are very happy with that system. We have the choice of whether we immediately buy it from the market to replenish our own reserves or whether we wait for a while and buy it from the market at what we think is a better time.

During that period, particularly during 1998, when on a couple of occasions the Australian dollar was under what we thought was quite unwarranted downward pressure, we did not want to push it or encourage it to go any further so, instead of immediately buying the foreign currency from the market, we waited. We just supplied it from our reserves and then found a more suitable time to replenish our reserves, and that is what we are doing at the moment. That is simply a standard relationship between us and the government—how we, as banker to the government, provide them with foreign currency.

It is also true that during 1998 on three occasions we did something more than that and we actually came in on our own account because we thought the market was threatening to become destabilised and an overshoot was threatening. I do not think there is any dispute that an overshoot actually occurred and certainly a bigger overshoot was threatening. The Australian dollar at one stage went down to 55c, you might remember, in August. That was

a classic overshoot, and we can see that now with the benefit of hindsight. So, in 1998, we actually did some orthodox intervention as well as, as I said, this ordinary changing of the timing of our role vis-a-vis the government as banker to the government.

CHAIR—If we could just separate out the two issues, certainly we appreciate the reasons why you felt that intervention on those three occasions was warranted, but is it not also the case that the level of the dollar was probably set a little bit higher than it might otherwise have been during that period because of this?

Mr Macfarlane—In the long run, it does not affect the level of the dollar because, although we supply the government with its needs from our own portfolio, we then replenish it from the market. So it does not have any effect on the long-run level of the Australian dollar. It has a little bit of an effect on the degree to which it fluctuates around that average long-run level and, you are right, other things being equal, it meant that the Australian dollar did not fall as far as it might have in 1998.

CHAIR—I am just relating that back to the facts on the current account because, if it had been allowed to fall a bit further, might that not have—particularly in the trade weighted index context—helped get a better balance between exports and imports?

Mr Macfarlane—I think if it had fallen, it would have fallen temporarily. It would still have come up the way it has come up. The Australian dollar did fall a long way in 1998. As I said, whichever measure you look at—the US dollar or G7 or the other measure we often use which is trade weighted index minus Indonesia—it fell a long way in 1998. Some people would look at that and say, 'Oh well, that is good, that is what we would like it to be, but one should keep it there.' The answer is that you cannot keep it there. The Australian dollar has risen during 1999, and it has risen for the reasons that I alluded to before, which were essentially international reasons. As people became more confident that the world was not going to go into a tail-spin—we were not going to have a world recession in 1998, as international financial markets became a bit more stable, as commodity prices, although not necessarily our commodities, started to recover—then the Australian dollar went up.

CHAIR—My other question then is: what is your general view about the current value of the currency?

Mr Macfarlane—It is an interesting question. It is a bit like someone being asked if they like modern art and answering, 'I don't know much about art but I know what I don't like.' It is a bit like that with a currency. Most of the time, if you have got a floating exchange rate, you basically just accept the judgment of the market. On fortunately rare occasions, you think the market has got it wrong and is overshooting, and that it is either too high or too low. But, for 98 per cent of the time, in a sense you do not have a view, because you say, 'That is where the market put it; that is the collective wisdom of the importers and exporters and capital exporters and capital importers, and I can live with it.'

CHAIR—Okay. Does anyone else have any questions on that? Otherwise we will move on.

Mr ALBANESE—I have a question on monetary policy, to go back to it again, and on two scenarios that you might like to comment on. You commented about how the Fed had eased monetary policy three times in the last year. What would the bank's response be to the Fed making a decision to increase interest rates and tighten monetary policy? That is one scenario.

The second scenario is a follow-on from a question that Mr Wilton asked. He referred to Ted Evans's evidence before the Senate estimates committee a couple of weeks ago, when the Secretary of the Treasury was asked what would happen to monetary policy and what the implications were, if in fact growth did not slow to the three per cent which had been forecast by the Treasury, and what the monetary policy response would be. He commented:

I think one would expect that if growth was strong enough to be heralding a problem on inflation, you would see a monetary policy response.

In response to Mr Wilton's question you said, 'If the growth was in fact three per cent.' But what occurs if in fact the growth is higher than that? I acknowledge that you were more right than most forecasters were, in your assessment of what the growth figure would be for the last year, but what would be the monetary policy response under both those scenarios?

Mr Macfarlane—Anthony, I would claim that I have probably answered both of those questions but I will have another ago. The first one was about whether, if the US tightens, we have to tighten. I gave a long dissertation on the state of the US economy and of the Australian economy and demonstrated that they were different and that the US having reason to do something does not necessarily mean that we necessarily have to do the same thing. I continue to maintain that point of view.

The second one is, essentially, about what happens if the economy is growing so fast that it threatens to cause inflation to go up. What do you do? The answer is that you tighten monetary policy. But the history of the last couple of years has been that the particular rate of growth that is required to threaten to raise inflation is a bit higher than we used to think. We do not have a particular number in our mind whereby we say that it has been reached and therefore that is going to be inflationary and we have to tighten.

Mr ALBANESE—So there is not a level of growth that you think would trigger—

Mr Macfarlane—That is right. There is no predetermined rate of growth. You would have to be looking at the multitude of things you look at when you are making an inflation forecast—and, of course, growth is one of the many things—and you would have to determine whether all those things in total were presaging a significant increase in inflation and, if they were, you would then tighten monetary policy. In that sense, I am saying exactly the same thing that Ted Evans said.

Mr LATHAM—At page 1 of the *Semi-annual statement*, talking about the impact of the currency depreciation which occurred between mid-1997 and 1998, there is a statement that this has not flowed through to inflation:

A key reason for the very low results recently has been that few tangible effects have so far emerged—

with that particular depreciation. Does that mean that, in your opinion, they will not emerge or that they are yet to emerge and that we are seeing longer lag effects pushing through the economy?

Mr Macfarlane—I think Mr Stevens answered something very similar to that a little while ago and said that we have continued to believe that some of them at least would eventually emerge, that this squeezing of margins could not fully compensate for the fall in the exchange rate. It could delay the inflationary effects, but it would not completely offset them, and we still believe that some of them will come through. Of course, in the meantime, the exchange rate has gone up so some of them will have been unwound by the rise in the exchange rate that has occurred in 1999. But regarding the ones that have not been unwound we still believe that some of them will flow through.

Mr LATHAM—On the question of lags, again the secretary to the Treasury has said that in his opinion our economy has been stress tested by the Asian experience and we have passed the test. Do you share that optimism, or do you think it is perhaps a bit too early to give that definitive judgment and there may be some lag effects that cause more stress than anticipated?

Mr Macfarlane—No, I think I would agree with him. The longer the expansion keeps going, the less plausible it would be for us to blame any subsequent problems on the Asian crisis, because I think the major impact of the Asian crisis has probably already come through. The period of contraction in Asia has finished. The Asian economies have by and large flattened out and are perhaps going upwards a little bit, so we have basically got through that particular stage, I think. What do you think, Steve?

Dr Grenville—I think that is right but, as well as that, we were never likely to be subject to the Asian crisis as it occurred. We were never likely to be subject to those huge reversals of capital inflow. The thing that we faced was the likelihood that the environment in which we worked would be less benign, we would be getting less demand from overseas. I think, to that extent, that is what we have already experienced and that is not going to get any worse; it is going to get better.

Mr LATHAM—Just on that depreciation, page 7 of the *Semi-annual statement* reads:

> The expectation and then the reality of the monetary easing in December . . . contributed to a decline in the currency . . .

late last year. Just on that choice of words, does that mean that, in some part—even a large part—the decision to ease was driven by the expectations?

Mr Macfarlane—The expectations of?

Mr LATHAM—The market expectations there would be an easing in monetary policy—almost like a stampede effect—that in the end you are forced to go down that path.

Mr Macfarlane—No, the easing of monetary policy in December was essentially driven by the fact that our inflation forecast was coming down. We were in a position where we

thought there was a more than reasonable probability that we would have a significant undershooting in inflation, and therefore some easing was warranted.

CHAIR—There will be two more questions on monetary policy and then we are going to move on.

Mr WILTON—Despite the overnight US federal inflationary index figure, expectations have probably remained that the federal reserve may tighten by the end of the month. That would mean, effectively, that they would take back one of the easings that they made—perhaps, say, for argument's sake, the December easing, which was made as an insurance policy against the global market crisis. Given the nexus between us and them and the fact that our December easing was a similar insurance, is the concept of taking back such a stimulus a consideration for the RBA?

Mr Macfarlane—I think when I was answering the question from Mark Latham I said that our easing in December was not at all like the easings that the US did. The US easings were a response to a temporary crisis, which has gone away. Our easing was in response to the fact that we thought the probability of a significant undershooting of inflation had risen to a high enough probability that we thought we needed to ease. So ours was not a temporary thing to cover a temporary issue; ours was much more longer term in nature.

Dr SOUTHCOTT—In your opening statement you talked about the micro-economic reforms that have led to increases in productivity growth. What do you expect to be the impact of indirect tax reform on the long-term output of the economy?

Mr Macfarlane—I think it is beneficial, but there is no way that I would know how to measure it or to quantify it. I have been asked this question before by this committee, and my general argument is that I think that some reweighting of the tax system away from income tax to sales, expenditure or GST type taxes would be beneficial for a number of reasons. The main reason is that it does something about relieving the very high marginal tax rates that apply in Australia on quite moderate incomes. So I think at the margin the direction is beneficial, but I have not the faintest idea how you would go about quantifying it.

Dr SOUTHCOTT—I do not know if you noticed, but the semi-annual statement said about Japan:

Consumer spending has been stagnant since the April 1997 consumption tax increase.

This was seized upon by opponents of tax reform. I wonder what you see as the main reasons for the stagnant Japanese economy and whether it was due to the consumption tax increase in April 1997.

Mr Macfarlane—Certainly our view is that the tightening of fiscal responsibility that was involved in that increase in taxes was a mistake. It was not the appropriate fiscal policy. Japan did not need a tightened fiscal policy in 1997. That is really the point we would make. It was not exactly tax reform; it was a macro-stabilisation policy which destabilised it.

Mr LATHAM—Winston Churchill once said that he was confident that history would record a favourable verdict of his time in politics. I now notice that the bank is writing its own history of inflation targeting in the speech that Mr Stevens gave in April. I want to ask two questions arising from that. You point out that in the current circumstances undershooting is not that much of a problem because what you really engaged in is inflation forecast targeting rather than inflation targeting. Do those comments about undershooting also apply to overshooting? If there was a sustained period where the inflation rates had overshot the mark but you are focused on inflation forecast targeting and you think your forecast is right and your trend is right, would you keep the overshoot in place as long as you have kept the undershoot on inflation and have the same level of comfort?

Mr Macfarlane—The first thing—to make it clear—is we did not aim to have the undershoot. We certainly would not aim to keep an overshoot in place either. The argument is that you set monetary policy to whatever level is necessary so that your forecast has you back in the range over some reasonable forecast period, like a year or 18 months. Yes, it is symmetrical in that sense. It is exactly symmetrical. The fact that you had undershot does not mean that you try to make up for that undershoot by an overshoot. Similarly—and I think this is very easy to understand—if you had overshot for, say, two years, even though you had not intended to, you certainly would not want to make up for that overshoot by undershooting for a couple of years. So accidental bygones are bygones. As someone said, even the worst archer aims for the bullseye.

Mr LATHAM—My second point refers to the quote, ‘There are maybe six things we have learned about monetary policy in two centuries of economists’ and others’ thinking about it.’ The first one given is that ‘Monetary policy affects principally or only prices in the medium term’. If it is not affecting employment in the medium term, does it still make sense for the bank to have employment related goals and have them written into its legislated charter?

Mr Macfarlane—The purist would say that the best thing that monetary policy could do is to just try to achieve a satisfactory outcome for inflation in the medium term or the long term. That would be the purist’s position. A number of central banks have enunciated that way. Our position is that history has demonstrated quite conclusively that if you want to have a sustainable expansion it can happen only under periods of low inflation. So in achieving that low inflation you will maximise your chances of having a sustainable economic expansion and you will, therefore, maximise the benefits for employment. Just go back and look at the decades you can think of. What were the low inflation decades? The fifties and the sixties where we had very good growth. What were the high inflation decades? The seventies and the eighties where we had weaker growth. What is happening in the nineties, a low inflation decade again? Much better expansion. In the medium term there is no conflict. You do not have to say, ‘Will I do this or will I do that?’ In the medium term the two aims work out together.

Mr LATHAM—I am not in disagreement, but what you are basically saying is that the employment role is incidental to the attitude where one policy tool—monetary policy—will hit one bullseye: inflation. Is it not better to have that accurately reflected in the legislation under which you operate?

Mr Macfarlane—I have no desire to rewrite the mandate. Even if a number of modern economists would say it looks a bit dated the way it is written—which I think is the point you are making—I would have no particular desire to rewrite the mandate. I am comfortable with having a reference to employment and unemployment in our mandate, and I am comfortable you can interpret it in a very economically sensible way, even though—as you are probably right to say—if you were rewriting it now in the light of current economic knowledge you would probably phrase it somewhat differently. But I am certainly comfortable with having employment and unemployment in the mandate.

CHAIR—Mr Macfarlane, on that point, until two annual reports ago the Reserve Bank for 40 years apparently always had a statement at the front of its annual report, which no longer appears there. I was just wondering—just as a little side issue—about that.

Mr Macfarlane—We have just cleaned up the presentation, that is all. We used to have that down the inside, then we had a letter to the Treasurer. The whole thing looked messy, and just in the interests of a cleaner and better presented annual report that change was made. But, no, as I have already said in answer to Mark Latham's question, we have no desire to go back and ask for a new mandate.

CHAIR—Can I move on to a couple of other issues. First of all, I have a quick one on derivatives. In the semi-annual statement you made the observation that a number of pension and superannuation funds in the US are shifting a portion of their investment into hedge funds. Also, in the March *Reserve Bank of Australia Bulletin* you made the observation that turnover in exchange traded interest rate derivatives has grown at an annual average rate of about 20 per cent in the past two years to around $37 billion a day. You also in that *Bulletin* noted that the end of December total value of off balance sheet business for banks was $3,286 billion compared with on balance sheet figures of $622 billion. Are you concerned about the level of exposure, particularly of the banks, to derivatives and about what that could mean to the stability of our current system, and about other related things to do with hedge funds and growth in derivatives generally?

Mr Macfarlane—Let us start with hedge funds. Most hedge funds are very plain vanilla institutions. I do not know how many hedge funds there are; no-one knows—3,000 or 4,500. I have seen these sorts of numbers quoted. The vast majority, 90 per cent of them, just operate in the US equities markets. All they do is take a position and buy one particular stock and sell the index. So all they are doing is punting that one stock will move differently to the index. That is perfectly respectable activity, and I suspect it is perfectly reasonable for even conservative funds to buy units in that sort of standard, plain vanilla hedge fund. The sorts of hedge funds which we have spoken about disapprovingly over the last year are a very small minority of what are called global macro funds. I do not know whether these US endowments are putting money with global macro funds. If they were doing that, I would be very worried; but, if they are just putting them with the plain vanilla hedge fund, I do not think there is anything particularly to worry about there.

You mentioned the figures on the growth of trading in exchange traded options and in derivatives. We have no particular problem with that. We think that exchange traded derivatives are a particularly well supervised way of dealing with derivatives. There are margin calls, you have to have a certain amount of capital and you cannot gear up infinitely

with exchange traded derivatives. The problem is not with exchange traded derivatives but with some of the off-change derivatives or the over-the-counter derivatives, as they are called. In some of those it is much more difficult to be sure that very sound practices are being used. But the ones that are traded on the exchanges like the Sydney Futures Exchange we are very comfortable with. We think that the big banks know what they are doing. By and large, they have very elaborate risk management systems and they take relatively small risks. In other words, they are offsetting each other nearly all the time in the sorts of positions they are taking. So at this stage I do not see commercial bank derivatives activities to be a risk and I do not see exchange traded derivatives to be a risk. I think the sorts of thing that worried us were the over-the-counter activities of some of the marginal and unregulated players such as the hedge funds.

CHAIR—So what you are saying is that you are monitoring the banks fairly closely—

Mr Macfarlane—APRA is monitoring them very closely.

Ms BURKE—Can I do my bank fees and charges now. I will try the Latham style and get a series of questions out here. I would like to start by thanking the bank for going to the efforts of producing the report. When we asked for it at the last hearing, you did indicate it would be a difficult report to produce. I accepted that. Thank you for going to the effort. But I would like to inquire as to why you chose only the six banks to get the fees and charges for. There are really not too many more banks left in the market anyway. Were they the only ones who have actually kept the data? Why is the data going back only to 1997? Is the data publicly available? If it is not available, can the banks comply with their uniform credit code requirements at the moment to disclose such things to customers? Was that a concern? Did you look at other sources of data like the ACCC, which is meant to monitor—

Mr Macfarlane—Not too many questions at once.

Ms BURKE—It is all about how you got the data and where. Did you look at the ACCC, which technically from the PSA inquiry did have a responsibility to at least monitor loosely, or did you look at something like Cannex? How did you go about collecting it? What did you look at and what were the limitations?

Mr Macfarlane—I think we looked as far and wide as we could and we decided that none of the data that were readily available and had been collected would be of use to us. We certainly cooperate quite closely with the ACCC and there are a couple of things we do together. I do not know with complete certainty, but I am confident that if there was any good data that the ACCC had that would have been useful for us we would have got it. We certainly have looked at all the commercially available monitoring agencies like Cannex. We came to the conclusion that there was not enough data available without us actually asking for more. Some of the data in this is, of course, publicly available. Graph 1 is publicly available. More importantly, table 1, the fees of major banks, which has attracted a lot of attention, is all publicly available information. Any customer can get that information. It is when we start going beyond that to tables 2, 3, 4 and 5 where we start to get into the data which is new data. We had to ask for that from the banks.

Why we chose six I do not know really, but six covers about 80 per cent. I have no doubt that the results would not materially change if we had included some of the smaller banks as well. I think the six is not a problem. We had to request this, and it is not the sort of data that is disclosed in their annual reports. You add it all up and it is in there somewhere, but the degree of disaggregation, as I understand it, where you actually break down the fees into account servicing fees, fees on loans and fees on transactions, was difficult for them to get. They had to go back and get that, and they could do it for two years. It would have been nicer if they could have done it for longer and I do not know why they could not have done it for longer, but, as I understand it, that was what they could get. It took them a long time to get it.

We took all this stuff very seriously. The data that they gave us has been signed off by the chief financial officer as being audited data. As I say, we have got it for 1997 and 1998. I myself do not think it would change the story very much if we had got earlier data. We know that we started from a position, under the regulated system, where fees were either zero or minimal. We now know what fees are, we now know what the revenue is that banks get from fees and we know what the end point is, so if we want to we can calculate the growth rates over that period. I do not think it would make a lot of difference if we had a whole lot of columns for 1994, 1995 and 1996. We know where we started from and we know where we have ended up. I think that is probably enough. I suppose what it does not do is answer the question whether they were extremely low for a long time and then just jump up at the end or whether they were growing smoothly over a period. It probably does not answer that question.

Ms BURKE—It would have been interesting to look at the point where the mortgage originators came into the market, because the banks' general excuse is that that is when margin squeeze really came about. That would go back to the late 1980s and early 1990s.

Mr Macfarlane—Mortgage originators did not really make an impact until about 1993 or 1994, I think.

Ms BURKE—It would have been interesting if they had had that. That is their excuse for them, I suppose.

Mr Macfarlane—My guess is that that is probably about right. You can see a bit of it from table 1. In principle, we could reconstruct table 1 on an annual basis. That does not tell you how much revenue they get but it tells you what the actual fees were. That is all published data. You could reconstruct that on an annual basis and you could see where the big changes occurred.

Ms BURKE—Leading on from that, do you think there is competition in the market? If you had that much difficulty disaggregating that information, how would a normal consumer, who is meant now to be encouraged to shop around to get the best prices, go about actually getting that information and coming up with a sound choice?

Mr Macfarlane—I think the consumer can get the information that they need. That is publicly available. I agree that it is more complicated, because each bank is slightly different and there are now so many things you have to consider: how much is the account keeping

fee? Is there an account keeping fee? How many free transactions do I get before the fee comes in? What is the fee? It is true that there is a lot of information per bank and there are a lot of banks, and so for an individual consumer unaided to be able to get all that information would be very time consuming, but it is there. We had no trouble getting that. That is published material. The bit that we had to get the special collection for was a different thing altogether which was not of relevance to an individual consumer.

There are commercial organisations which assist consumers to make decisions. A lot of the newspapers have a journalist who has specialised in this who writes in the personal investment pages of the newspapers. It is much more complicated, I agree. You are in a particular bank and you do not know whether there is another bank which will give you a much better deal. We can only hope that more and more information becomes available. We went through this initially on the mortgage side when suddenly competition entered into the provision of mortgages. One of the things that happened then was that banks actually charged different interest rates and had different facilities that went with each mortgage. When that first happened, that caused confusion too. Consumers had a lot of trouble working out where the best deal was. My understanding is that in time that has worked its way out. There are mortgage brokers who will tell you what is the best deal; there are services you can consult which will tell you where the best deal is. I suspect that will happen with just opening and running a transactions account.

Ms BURKE—My final one on this is that you note in the report that overall someone with a mortgage is doing better than someone who does not have a mortgage—that is, pensioners and people who must use bank accounts. Would your summation be that under the fees and charges regime they are actually worse off?

Mr Macfarlane—Leave pensioners out for a moment but I will come back to them in a second. Essentially what we are dealing with here is a change in a regime—from a very heavily regulated regime where banks made all their money out of their interest margin and they cross-subsidised transactions to a regime where they no longer make as much money out of their interest margins and they charge for transactions. It therefore follows axiomatically that if you are a borrower you are much better off under the current system, because you are no longer having to pay the subsidy to another group of people. If you were only a transactor and a recipient of the subsidy and you no longer get the subsidy you are worse off. I think that just has to happen. If you break down a system of cross-subsidies and replace it with something which is much closer to user-pays, that always happens.

As for pensioners, I understand there are at least two banks which offer accounts to pensioners which have no account keeping fees and they have reduced transaction accounts. This is one of these things where I do not know all the detail. My understanding is that if you are a pensioner or a student you have a very high chance of not paying fees.

Ms BURKE—The PSA inquiry actually did make the recommendation that there be a no-frills account offered. I am not sure that all banks have gone through with it. ANZ certainly came under a lot of flak when it tried to introduce fees for the students and under-18 accounts. It is a difficult question, but do you think the banks have a social obligation?

Mr Macfarlane—I am not sure about the arguments for or against providing this group or that group with a subsidy, because every group can say, 'I am a particularly needy group.' When it is students, is it secondary students, is it tertiary students—when do you actually cease being in a special group that receives a subsidy and become like a normal member of the community? I do not know. It is a very complex issue. But I can understand that when you move from one system to another some people gain and some people lose.

Mr ALBANESE—Following on from that, the study found that there was a 30 per cent increase from 1997 to 1998. I think the figures were $1.095 billion up to $1.410 billion in one year just from household fees and charges. Do you understand that out there in consumer land they find it difficult to comprehend that those increases are reasonable? If they reasonable, at what level do they become unreasonable?

Mr Macfarlane—I do not know what level is reasonable or unreasonable. I am sure you would need an extremely good cost accountant to work out what was reasonable or unreasonable. I do not know what is reasonable, for example, for a cheque. I do not know what the reasonable level is. I cannot answer that other than by saying that, if you start at zero and move to whatever level is the appropriate economic level on a user-pays principle, the rate of increase will be high. If you start at zero and go to some finite number, the rate of increase is going to be high. I do not know that I am in a position to judge what is reasonable or unreasonable for a particular fee.

Mr ALBANESE—There is scepticism out there amongst the people that we represent, when the Treasurer said some time ago that red-hot competition was going to make sure that fees and charges stayed down and consumers can look at their statements and see an ever-expanding number of costs, at the same time as they see on the front page of the *Daily Telegraph* how much profits banks have made—let alone getting into the trickier area of how much the CEOs of these banks have been paid in recent times and how much their payouts are when they go on to other employment. With the level of scepticism which is there about competition, with the view that is certainly put to us in less sophisticated terms than that 'competition is bad', and with the demonstrations outside banks—which are closing in electorates all around Australia—do you think that the banks really have got it wrong or that the competition model is failing, when you have all those circumstances occurring at once?

Mr Macfarlane—The first question is whether competition should drive down fees. The answer is probably no. The main thing that competition did was to drive down margins. It drove down margins and caused fees to occur. The competitive model is basically the user-pays model, which says that, in any high profit activity which is the source of the cross-subsidies, those profits will get squeezed. And that is basically what has happened. From our perspective, if you wanted to feel upset at the lack of competition in Australian banking, it was in that period that the margin on housing loans was about four percentage points, which was very high—and we said so at the time—by world standards. We were surprised that competition had not driven that down.

The nature of competition is that it drives down those things where very high profits are being earned, as with mortgages, but as it does so it prevents companies—whether they be banks or other companies—from subsidising those areas where they are actually losing

money. So the main effect of competition is to squeeze margins, and that means that you can get a better deal on your borrowing or lending but it raises the costs for running accounts and having transactions. It seems to me that that is absolutely inevitable.

There is no way that that could have been avoided, other than by going back to the old system whereby the government set the interest rates—which is what we had in the 1950s and 1960s. The government set every interest rate, every lending rate and every borrowing rate. In that world, the only way the banks could compete with each other was to be the one who got the most deposits, and so they provided these activities at a subsidised price. That is the only way you could do that. It is wrong to say that competition would somehow or other put downward pressure on fees. Competition would not put downward pressure, initially, on fees. Initially, competition would lead to fees being charged that formerly were not being charged.

The second issue is that of bank profits. I, like you, have often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia in this period. They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high.

Our first thought was that maybe it was because, even though the margins had gone down by X, fees had gone up by X plus something. We thought that that might be the explanation and that would be very disturbing. My predecessor used to say that he had no objection to bank fees as long as the rise in the fees did not just make up for the fall on the margins—as long as, in net terms, banks' customers got something. This piece of research indicates that in net terms, in very rough orders of magnitude, customers on average have gained 1.25 percentage points since 1996 out of the squeeze in margins and they have given up about 0.6 or 0.7 of that by higher fees. So, if you were the average customer who had some transactions, a loan and the whole lot, you would have come out ahead.

If the customers have come out ahead, why haven't banks' profits gone down? The answer is that banks' profits have not gone down because they have cut their costs very sharply, and there is a graph there that shows that. The capacity to maintain profitability has not been due to the imposition of fees; it has been due to the cost cutting they have undertaken. And, of course, that has a social implication as well. I do not think it has a huge implication in the cities because you can run with a smaller number of branches or a smaller number of tellers. Young people, by and large, are not interested in going into bank branches. It is mainly older people that go in there. There has actually been a clear reduction in demand for face-to-face services from banks. It is more difficult in the country areas where the choice is either one bank or no bank, and you have no bank. I accept that is a serious problem.

Mr ALBANESE—I accept what you are saying with one proviso, which is your view of the average customer being someone who has a loan and also conducts transactions. If that were the case, if that were across the board, then, yes, the effect would be a benefit. If, however, it is a fact that there is a whole section of the community which has not got the benefit of interest rates, then there is certainly an argument there in terms of the impact of

the transfer from interest rate benefits to bank fees and charges. In fact, what has happened is a massive cross transfer from the people who do not have loans to those who do engage in those transactions, and the equity implications of that, I think, mean that the average consumer does not exist, that there has been that transfer, and an inequitable transfer has resulted.

Mr Macfarlane—Certainly the transfer has resulted. I am not sure whether you can necessarily say it is inequitable because it really is the withdrawal of a subsidy. One group of people subsidise another group of people and now that group of people are no longer subsidising the second group of people. If you were in the second group of people it certainly looks to be inequitable, but I am not sure in absolute terms whether we can say it is inequitable. It certainly has had distributional consequences.

Mr ALBANESE—That is right if banks have an attitude of pure profits, but it is different if it is a matter of margins. This committee, for example, heard in the rural banking inquiry that banks were closing branches not because they were not profitable but because they were not profitable enough. Hence it is an argument, in terms of the subsidy, that the average pensioner customer was not actually costing a lot of banks but that banks were not making enough money out of the average pensioner customer compared with the higher investor. If you take that into account, then certainly there is an equity consideration.

Mr Macfarlane—I agree very much with one aspect of what you are saying. Any business, whether it is a bank or any other business, if it is aiming for extremely high rates return on equity—if it is aiming for 18 or 20 per cent in an environment of two per cent inflation—it seems to me there are an awful lot of very useful things that could be done which are profitable, but they are not quite that profitable. I accept that point.

CHAIR—On the question of bank fees, in table 6 in the discussion paper which you published on bank fees there seem to be a lot of parts excluded which were in earlier tables; for example, fees on business deposits, bills, merchant service fees and those referred to as 'other' back in table 3. If all those fees identified in earlier tables were included in table 6, how would that affect some of the conclusions and arguments which follow that?

Mr Macfarlane—We do not think merchant service fees have gone up. The total amount of money has gone up from $585 million to $750 million, which is a 28 per cent increase. That is just because there have been 28 per cent more transactions. Basically, people have started to use credit cards a lot more because of loyalty programs. Merchant service fees—the money shopkeepers have to pay credit card providers—have not changed since the 1970s. The cost for accepting or endorsing a bill has not really changed since the 1970s. Those sorts of things are very widespread. We have included the ones where we think a change has occurred.

Mr WILTON—Governor, the bank's study found that between 1997 and 1998 banks earned an extra $215 million from household fees and charges and in the same period an extra $205 million from business fees and charges.

Mr Macfarlane—Yes.

Mr WILTON—Does that indicate that households are subsidising business? If it does, is that a concern for the bank?

Mr Macfarlane—I do not think that is the case. In terms of level, we have established that businesses pay a lot more in fees and charges than households. At the beginning, the figures were $1.4 billion for household fees and charges and $3.1 billion for business. So businesses are paying more than households. In terms of rates of change, it is very difficult to judge, because if you start from almost nothing and move to something that is even moderate, the actual rate of change is going to be very high as you make that movement.

CHAIR—In table 4, total fee income comes to $4½ billion. If you divide it by the deposits of the six banks which you have surveyed, you would find the fee income around 1.8 per cent of deposits, which seems to be a bit higher than in table 6. I am trying to clarify that. Does that mean there is still some work to be done, as you suggest in the discussion paper?

Mr Macfarlane—The calculations that we did at the back where we compared the rise in fees and the fall in margins were for households. The fees on businesses have not changed all that much. We have really concentrated there on households, whereas the figure you are quoting, the $4.5 billion, is the sum of households and businesses.

CHAIR—Are you saying that the 1.8 is, therefore, roughly equal?

Mr Macfarlane—It should be $1.4 billion for the households. That is the total amount of fees they pay. We are treating that as though that was the change. We are saying that $1.4 billion is the total amount of fees. Let us assume all that $1.4 billion was raised between 1996 and 1998 and compare that to the fall in margins that has occurred between 1996 and 1998.

In terms of household fees, we have, if anything, overstated the change in household fees. But you are right: we have not added household and business together. I think this thing shows that basically business fees have not changed that much. There were always substantial fees for establishing a bill facility or these sorts of things. There have always been substantial fees in banks' dealings with business; it was banks' dealings with the household sector where there were minimal or zero fees. That is what we addressed in this study.

CHAIR—Do you feel it might be worth doing a bit more work on it?

Mr Macfarlane—Yes, I think we probably will do more work because I think there is a different constituency altogether, the business constituency, which is also interested in the subject. But we interpreted the request from this committee to be really the householders, the pensioners, the students—all the people who have transactions accounts and are worried about account keeping fees, transactions fees and loan fees. I think the introduction to this said it is unlikely that you will get the full picture in the one go, certainly on margins. It took us three or four before we really came to grips with what was happening.

Mr ALBANESE—I want to follow up on your answer to my questions earlier. You spoke about how the alternative in terms of margins with interest rates in the fifties and sixties was for the government to set interest rates, and I think that no-one would want that. But isn't there another side of the equation, which is whether or not there is a role for government in monitoring and perhaps some form of regulation of banks' fees and charges? You answered one half of the question, if you like, but at the other end there is certainly an argument for a role for government to intervene and regulate.

Mr Macfarlane—I would only think there is a role if you could demonstrate that fees and charges were going up much more than the fall in margins. What has happened is a redistribution because group A was subsidising group B. Now what is happening is that group A is no longer subsidising group B. As long as it is just a distribution amongst customers and the overall benefit to customers is going up, I do not think there is a case for a government to monitor or to set limits. But obviously if there was gouging going on—if the fees were going up much faster than other benefits were accruing—then the situation would be different.

Mr ALBANESE—You seem to accept at least some of my argument before about relative profitability in terms of customers. Isn't there an argument that, if you could show that the cross-subsidisation argument was fake in that customers who were not also borrowers were not costing the bank money, that in fact exorbitant bank profits were being made as a conscious strategy to drive away those customers—there were examples in the regional banking inquiry: a bank closes in a country town, it literally just sends a letter to the customers it does not care about and says, 'You're now deposited 300 kilometres down the road,' but provides personal banking services for, say, the most profitable large landowners or what have you—the test of whether regulation would be on equity grounds would be a legitimate policy response, whether or not that could be proven, whether or not the customer was in fact cross-subsidising, whether the cross-subsidisation argument was valid or not or whether it was a question of relative profitability of customers?

Mr Macfarlane—There is a role for many parts of the community, including this committee and governments, to put pressure on and exhort banks to think of customers who do not have many alternatives, if in fact these people have their banking services withdrawn because banks have set themselves unreasonably high profit hurdles over which they have to pass. If they have set these extremely high hurdles, there is a very strong role for governments, political parties, consumer groups and so on to exhort banks to review the attitude they are taking to branch closures.

Actually, you have had a fair bit of success already. A couple of banks have actually looked at it again and changed course. There is a case for doing that. That is certainly different to putting a legislative limit on how high a bank fee can be, and certainly different from passing a rule saying that a bank is not allowed to close a branch. I certainly think there is a very useful role for committees like this and for government and political parties to keep the pressure up on banks to justify why particular closures have occurred.

That is a very useful thing to do, because, not just banks, but a lot of other businesses have set themselves unrealistically high hurdles in terms of a greater return on equity. If they

are literally doing what they are aiming to do they are failing to invest in a lot of things which are reasonably profitable and socially very useful.

Mr ALBANESE—If they do not respond to that political pressure, is there a role for regulation?

Mr Macfarlane—I do not know. What would the regulation be? Would you pass a law saying that they are not allowed to close branches?

Ms BURKE—Or should there be a law saying that they cannot move?

Mr Macfarlane—I do not want to get onto that one.

CHAIR—Unless this is a burning issue, we might move on to some of the other matters. I want to come back to Y2K. At the last hearing you were rather keen to talk about the need to educate, and I am sure that your opening remarks were designed very much to further that. What other education should be undertaken and who should be responsible for doing it?

Mr Macfarlane—As I said, the first thing was to get all the financial institutions to speak in very simple language to their customers and tell them that the most important fact is about the safety of deposits. There are two things that people could be worried about: one is minor inconveniences or delays, which I do not think is going to cause massive public reaction; and the second thing is that somehow or other their records would be lost and their wealth would disappear from their bank deposits or from the various building societies, credit unions or other financial institutions where they store their wealth.

It is the second one that had the potential to be very worrying, because that was the one that led a few people to say, 'Take all your money out of wherever it is and put it under your mattress.' If that had happened on a very wide scale, that would be potentially enormously disruptive for the community. It was that sort of reaction that we have to make sure does not happen. That is not a technical problem. That is not because a particular system has failed; it is because people have overreacted. We have to make sure that does not happen.

I am actually very confident that that will not happen. Every serious body that has looked at it comes away with the conclusion that there is no problem on that score, and that banks, building societies, credit unions, et cetera, are not going to lose your records. I know we spoke to the Consumer Association of Australia and their data processing experts on the matter, and they are completely confident about it. They do not think there is a problem there at all; we do not think there is a problem there at all. The main public education is to make sure that people do not fall victim to the doomwatchers on that score. I think that one will be won. There will only be a tiny minority of people who would be worried on that score.

On the other score, there are people who will say, 'I'm not worried about that. I know my deposits will be safe, but I just want take out a bit more because who knows what's going to happen.' For those people, a few reasonable things could be said. The main one is:

it really is only a long weekend. Christmas and New Year are the Monday and the Tuesday, and then there are three working days—Wednesday, Thursday and Friday—where everything will run as normal. New Year's Day is the Saturday, and then there is Sunday of course. We think everyone will have a public holiday on the Monday, although that has not been finally decided yet. So it will really just be the Saturday, Sunday and Monday that will be the exciting period—that is when people are going to be out celebrating. That will be the start of the new century. By Tuesday, all the shops, banks and building societies will open their doors again and life will go back to normal. If there are bugs in the system, they can be overcome because people will just go back to the normal, manual way of doing things. If people want some more money to put in their wallet, they will just go to that institution and the teller will hand it over.

Dr SOUTHCOTT—Have you looked at other dates, apart from 31 December 1999? There has been some suggestion, I think, that 29 February could be a particular problem as well?

Mr Macfarlane—A whole lot of these are coming out of the woodwork at the moment. A number of people are saying that all sorts of problems are going to erupt on the 9th of the 9th 1999. Then, of course, there is the leap year in February. I am not personally looking at these things. I do not profess to be an expert on the technical side of this at all. Yes, people are looking at these, but I would be very surprised if they amount to anything. I would be very surprised if they could be as important as the new century.

Mr LATHAM—You sound very confident. The communications minister is going to fly in an aeroplane at midnight on 31 December. Maybe you should sit in an ATM machine to reassure the public that all is well. I want to ask a question of the Governor to get his response to the suggestion by the respected global economist David Hale that there might be some advantage in commodity currencies converging and forming a group led by the Australian currency—in his words, 'Making sure that our governor no longer has to sit in the lobby while the G10 central bankers meet'. What sorts of advantages could there be in David Hale's suggestion?

Mr Macfarlane—You are right—David Hale is a respected international economist. Unlike most American economists, he has actually got a very international outlook. He has written a fair bit about Australia over the last decade or so. He is a great student of the Australian dollar. This is not the first time he has written pieces about the Australian dollar. He has claimed in the past that the US should use as an indicator of monetary policy what is happening to the Australian dollar. He has touted this suggestion around the US on a number of occasions and his views are widely known in the US. The Fed response is: 'Yes, it's all very interesting but, if the Australian dollar is moving because of commodity price movements, why look at the Australian dollar? Why not look at the commodity price movements that underlie the movement in the Australian dollar?' That article was quite interesting and that is about the third time I have seen it. It was actually written in opposition to some other economists who were saying that Argentina's solution of a currency board was a very good one. He was saying that it was a terrible solution and that Argentina would have been much better off if it had fixed to the Australian dollar instead of via the currency board to the US dollar.

Mr LATHAM—My final question is back on my pet hobbyhorse of national savings. Governor, today you seem to have indicated the role of monetary policy is inflation targeting and the role of fiscal policy is public savings. Don't we need a third leg in this country of a private savings plan beyond superannuation, a pre-retirement savings strategy that does something about our chronic paucity of national savings?

Mr Macfarlane—You really have three policies there—monetary policy, fiscal policy and retirement incomes policy. You are saying that there should be a fourth about non-retirement savings policy.

Mr LATHAM—Pre-retirement.

Mr Macfarlane—I am not sure whether I would agree there has to be a fourth policy. I don't know what you would call it. I certainly think in the very long run, if there is a shortage of savings, you can get into trouble, as I explained, but the main trouble you would get into if there were a shortage of savings would fall under the heading of retirement incomes policy. I don't know whether you would call it a special policy. I think what you are talking about is that you should be reviewing all the time structural aspects of your economy to see whether some of them are inadvertently having an antisaving effect—for example, if your tax policy is leading to a reduction in savings. I think you should be reviewing those things all the time, but I am not sure whether I would call it a fourth policy.

Mr LATHAM—Singapore called it self-provident social insurance. Are you impressed by that model?

Mr Macfarlane—The Singaporean model is a very interesting one. A very large part of it is just retirement incomes policy, but the other part of it was a deliberate decision on the part of Singapore, because of its military vulnerability, to make sure that basically the physical assets of Singapore were owned by foreigners and that the savings of Singaporeans went into owning assets that were held abroad. I think the Singaporean one has a specific strategic, military basis to it as well as a retirement income basis to it. We do not have that particular Singaporean issue.

Mr WILTON—My question takes Mark's question on commodity based currencies back a peg or two or three. Given the closeness of our trade links and the similarity of our monetary policy settings, would the bank at any stage countenance a single currency arrangement with New Zealand?

Mr Macfarlane—We haven't given any thought to that. I think the reason for that is very simple. If anything like that were to be progressed, it would have to be from the New Zealand end. The benefits, such as they are, would mainly accrue to the smaller country rather than to the larger one. It is not an issue that we have really given any thought to.

Ms BURKE—I have an unrelated question about your role on the APRA board. We heard a lot of concern about the levies that APRA is about to charge and the million dollar cap on the major banks. Would you be more attracted to keeping the non-core deposits, which the banks are looking very forward to come July, or do you think there should be some review of the legislation that actually has already been put in place?

Mr Macfarlane—The ending of non-core deposits was an implication of the Wallis inquiry. My understanding is that the Wallis recommendations received joint support from both parties. As far as I can see, it is non-negotiable.

Ms BURKE—Do you share the concerns? We certainly had a lot of complaints from foreign banks and smaller players. People who have dual licences are going to be up for an inordinate amount of money and disproportionate, especially if the million dollar cap applies to the majors.

Mr Macfarlane—I think the issue of dual licences is a problem. I think that is a result of the legislation that would require a change in legislation to overcome. I think people are looking at it.

Ms BURKE—My other question is on employment. The move to APRA has seen a pretty savage aggression for staff to go on to AWAs. Is the Reserve Bank looking at that when your EV comes up at the end of next year?

Mr Macfarlane—No, we are not looking at AWAs.

Mr WILTON—Governor, the Federal Reserve I think recently has started to issue what it calls monetary bias statements immediately following Federal Open Market Committee meetings when it wants its views made known. We know that you have shied of the prospect of releasing, for example, minutes of bank board meetings, but is there any possibility that in the future the RBA would countenance a similar issuing of monetary bias type statements?

CHAIR—And possibly the minutes on a delayed basis?

Mr Macfarlane—I am not sure what value there is in that, particularly if you put on a bias and then you take it off again. That is what the US Fed did. Basically, they had a bias to tighten in the middle of 1998, then next month they took it off and the month after that they lowered interest rates. I am not sure what value people got out of the fact that they had this statement saying, ‘We have a bias to tighten,’ because it certainly did not give them any indication of the future development of US monetary policy. I myself think it is just another complication. People think this release of minutes is a great idea, but my suggestion is that you go back and read some of the minutes and see whether you think it is a great idea after you have read them.

Dr SOUTHCOTT—When they move to bias, do people actually start changing their activity, their behaviour?

Mr Macfarlane—My guess is that usually these days it is not important because these days the market is making an assessment. If the numbers are coming in that are indicating, for example, that an inflationary threat is increasing, it is built into the interest rates the day the information comes in. By the time the Fed comes along and says, ‘We’ve got a bias to tighten,’ in all probability everyone will say, ‘Oh yes, we knew you would because we’ve seen the numbers too and they don’t actually contain any extra information.’ I think that is what would happen here.

Ms BURKE—In your report to us you talked about the Reserve Bank being ready for Y2K and implications for pensions. Have you looked at the change of pension date and whether that is going to have any impact for you?

Mr Macfarlane—We are not in favour of a change of pension date. We are in favour of 'business as normal' on everything.

Ms BURKE—Have you put in some measures? It is coming soon. I am talking about the nomination of pension date as opposed to the Thursday.

Mr Macfarlane—Whatever comes in, we are not in favour of changing it when we reach 1 January.

Ms BURKE—You spoke to us at the last hearing about the changes in July opening up competition for the bank so that other players can come in and tout for your business. Are you still confident of that? If not, do you think that will have implications for employment levels in the reserve?

Mr Macfarlane—As I explained last time, this is a government decision, not a Reserve Bank decision. It is a government decision to tell all government agencies that they have to put their banking business out to tender. It is occurring much more slowly than we thought, but it is still occurring. We have been entering those tenders and we have had no change of policy in that respect.

CHAIR—I think we have had a very good innings. I thank you, Mr Macfarlane, Dr Grenville and Mr Stevens, very much for coming to today's hearing.

Resolved (on motion by **Mr Wilton**):

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

Committee adjourned at 1.08 p.m.