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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 1998-99

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Monday, 29 November 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: Ms Gambaro, Mr Hawker, Mrs Hull, Mr Latham, Mr Pyne and Mr Wilton

Terms of reference for the inquiry:

Reserve Bank of Australia's annual report 1998-99

WITNESSES

Committee met at 9.59 a.m.

CHAIR—I declare open this public hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration. I welcome everyone here today, particularly the Governor of the Reserve Bank and other senior representatives of the bank, members of the public and members of the media.

In 1996, the government and the Reserve Bank agreed that twice a year the Governor of the Reserve Bank 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 1998-99 and the first annual report of the Reserve Bank's Payments System Board, which have also been provided, will be drawn upon during today's inquiry. The bank has participated in these hearings for a number of years. It is generally agreed that the hearings provide an excellent opportunity for the parliament, the financial sector and also for the wider community to monitor the way in which the Reserve Bank conducts its business and makes its decisions about monetary policy.

The hearing has come at an opportune time. There is considerable public interest in the recent interest rate increase, and there are media and financial sector suggestions that inflation is once more looming as a possible economic problem. The Reserve Bank has a crucial role to play in dealing with these issues. The committee obviously also has an interest in the submission—which it will authorise shortly—on business bank fees.

[10.00 a.m.]

LAKER, Dr John Francis, Assistant Governor (Financial System), 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—Welcome. I remind you that the evidence you give at this public hearing is considered to be part of the proceedings of parliament and I therefore remind you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament. Mr Macfarlane, I understand you would like to make an opening statement before I invite members to proceed with questions.

Mr Macfarlane—That is right, Mr Chairman. I am going to do so. Before doing so, I should mention that it is a pleasure to be here again in these particularly dignified surroundings to appear before the committee. As you know, we take these hearings very seriously because we regard them as an important channel for parliament through its representatives on this committee to question the Reserve Bank in depth and it thus plays an important role in ensuring the bank's accountability and in the democratic process itself.

My opening statement will not be particularly comprehensive because we have only just recently put out our *Semi-annual statement on monetary policy*. We put this out earlier this month and its contents are still very current. I will refer to it from time to time during the hearing. Also following past practice, I would like to start by reviewing what I said to you in June about how we saw the economy developing. There was still a fair bit of uncertainty around at that stage as to the extent of the expected slowdown in GDP growth from the 4½ per cent plus that had occurred in calendar 1997 and 1998. That is why we put to you a relatively wide range of projected outcomes for calendar 1999. We said growth would be somewhere between three and four per cent. The top of that range would indicate almost no slowdown while the bottom would probably indicate we were heading still lower and would represent genuine weakness in economic activity.

We think the position is a little clearer now. Our forecast for growth through calendar 1999 is 3½ per cent and through the financial year 1999-2000 is four per cent. Through the year growth rate of four per cent implies a year on year growth rate of 3½ per cent, the same as the Treasury forecast in its mid-year review. Thus these numbers do show a modest slowdown for the Australian economy: as I said, 4½ per cent or so in calendar 1997; 4½ per cent in calendar 1998; and 3½ per cent through calendar 1999. There is a little bit of a slowdown but most of the slowdown is behind us. The slowdown for calendar 1999 incorporates the low June quarter figure and reflects weakness in business investment and particularly a decline in net exports in the first half of 1999.

Moving on to inflation, we see no reason to change our view. We thought in June that, in the year to the December quarter 1999, inflation would be two per cent, whether measured by the CPI or by some underlying measure—we still think two per cent for the CPI and a shade over two per cent in underlying terms. When we look out to June 2000—in other words, we look through the financial year—our guess for the CPI is 2¾per cent with 2¼ per cent in underlying terms.

On unemployment, we have also not changed our view. When we met last time, the unemployment rate had been averaging 7½ per cent, and we expected it to edge down over the remainder of the year. This has now happened, so that it has been averaging 7.2 per cent over the last three months. We expect that it will go down further and that we will see some numbers with six in front of them by June next year.

The balance of payments has also turned out very much as expected. For quite a while, we had been forecasting that the quarterly current account deficit would reach six per cent of GDP, and it finally did so in the June quarter and will probably remain at about this level through the rest of the financial year. It was surprising that the current account did not deteriorate faster and further, given the disparity between our growth rate and that of our trading partners. While the slowness of the deterioration has been a pleasing development, we think that the improvement could be some time in coming.

In summary, we are expecting that the current financial year will be another good one for the economy. Growth will be a little lower than its recent peak, but still good, and inflation should be within the average we aim for. Considering that this is the ninth year of the expansion, such a result would mean no major imbalances had emerged. The aim, as usual, is to keep the expansion going and to avoid the emergence of problems that would threaten its continuation.

This brings me to monetary policy. The most important development here was the tightening immediately after our November board meeting when the overnight cash rate was raised from 4.75 per cent to five per cent. While I think this adjustment had been quite well received by the community, it is still worth spelling out some aspects which lay behind the decision.

I would like to start by putting it in the international context, not because we have to follow what other countries do but because there are some international developments that are a common background to all countries. One such development was the changed perceptions about the world economic outlook for 1999 and 2000. If you remember, 1998 was a weak year for the world economy, largely because of the widespread fallout from the Asian crisis. At the beginning of this year, things looked as though they were getting worse, and most forecasters—public and private—expected 1999 to be a weaker year than 1998. In the event, it turned out the other way—1999 has been better than 1998, and 2000 should be better again. As our semi-annual statement said:

> This change has led to an increase in both short-term and long-term interest rates in most industrial countries, as markets questioned the continuation of the accommodative monetary stance central banks have generally been following over the past year or two. The upward pressure on interest rates began in the US, the country most advanced in its economic cycle, but quickly spread to other English-speaking countries and, more recently, to Europe.

This market reaction, described in that quotation, was probably a bit quicker than it needed to be, but it was broadly correct. The United States was the first to tighten, followed by the United Kingdom. Our tightening in early November was quickly followed by the European

Central Bank and the central banks of Sweden, Canada and New Zealand and, of course, the US and the UK also added to their previous tightenings in the last three weeks.

I would now like to turn to the Australian economy, where a similar expectation of weakness in 1999 did not come to pass. Real GDP grew by over four per cent in the 12 months to the June quarter, which is still the latest data that we have, and will probably be still showing a similar rate in the 12 months to the September quarter when that comes out. This 12-month annual growth rate may slip for a time as we drop off some of the high quarterly growth rates from our calculations but, as explained earlier, we think growth will be four per cent by the time we reach the June quarter 2000.

Similarly, the quite lengthy period during which inflation was undershooting our target seems to have come to an end. The CPI inflation rate would already be a bit over two per cent were it not for the government's reduction in the health insurance rebate that will drop out of the figures soon. Although some of this result has been due to rising oil prices, measures of underlying or core inflation, which are largely unaffected by oil prices, have also risen by about two per cent over the past 12 months.

Thus, the period where the Australian economy was experiencing a contractionary impact from abroad and where the outlook was for weaker growth and sub-two per cent inflation has now passed. The monetary policy that was appropriate for that period is no longer appropriate for the new circumstances that we face. That is the reason behind the tightening of monetary policy we undertook after our November board meeting.

At the risk of being overly technical, I would like to spell out some aspects of our flexible inflation targeting regime a little more fully. In doing so, I want to distinguish between two types of situation. The first is where inflation has been comfortably averaging two point something per cent for some time and the economy is performing roughly in line with its potential, so there is no obvious upward or downward pressure on the inflation rate. The second is where the starting point is either above or below the range that we expect inflation to average.

The first case is easier. In the first case, where inflation is where we want it, monetary policy would be set to keep it there. The economy would be in a type of dynamic equilibrium and there would be no need for policy action. We then ask ourselves: what are the circumstances under which we would wish to change monetary policy? Would we do it if our forecast for inflation rose from 2½ per cent to 2¾per cent, or fell to 2¼ per cent? My answer is that we do not worry about small variations in inflation of that magnitude. To trigger a change in policy would require a forecast which had inflation clearly going above three per cent or below two per cent and likely to stay there for quite a while. Our flexible inflation targeting framework does not aim for rigorous finetuning, and requires a significant variation in the inflation forecast to trigger monetary policy action in that circumstance.

So that was our first case where we started from the position within the band. This brings me to the second case. This is where we start from a position where inflation is above or below our desired target range. In this case, where the initial situation is one of dynamic disequilibrium, the prescription is a little more complex. Let us look at the situation defined by two possible starting points. The first is where inflation is above the target. In this situation, the inflation targeting framework would say to raise interest rates to a setting which would bring inflation back to the target. But once the higher rates had done their job, they should be gradually reduced to more normal levels. That is what happened in 1996 when we eased. We did not wait until our forecast had inflation falling below two per cent before we started to ease. We eased well before that.

The second situation is when inflation is below the target. In this case, the framework would first call for a setting of interest rates which would, over time, allow inflation to go back up to the target. Once it is clear that such a setting had done its job, the framework calls for it to be replaced by one more likely to keep inflation at the target. The framework does not envisage the low interest rate setting being maintained until something goes wrong.

It is this reasoning which lies behind the recent tightening of monetary policy and why we refer to it as pre-emptive. To argue against it on the grounds that we should not act until our inflation forecast clearly exceeded three per cent would be to argue for a very stop-go approach to monetary policy. It would be equivalent to saying that the most expansionary setting reached during the downward phase of the interest rate cycle should be maintained until such time as a move to a clearly restrictive setting is required and only then should a move be made. This would virtually guarantee that such a move would be a large one. It is a course which, as you know, we did not follow.

Not everyone will be convinced by the arguments I have used above. Some people still cannot understand why you would tighten, unless the economy was already overheating, and assume that there must be a hidden agenda. Others are keen to play the old game of trying to find a political dimension to monetary policy. This has led to claims that the real reason for the tightening is our fear of the inflationary effects of the GST but that we are too diplomatic to say so. I am sorry to disappoint proponents of this view, but that is not the case. If a GST were the reason for tightening monetary policy, why have the Fed, the Bank of England, the European Central Bank, the Bank of Canada, the Reserve Bank of New Zealand, et cetera, also tighten monetary policy? As I have said elsewhere, I am not aware of the forthcoming introduction of a GST in any of those countries.

Our starting point has always been that the imposition of the GST will affect the level of prices but not the ongoing rate of inflation. This will require that businesses do not engage in opportunistic pricing by raising their prices by more than is warranted by the net impact of the GST and the reduction in the other indirect taxes. If that is the case—and we assume it will be—the GST should not have an effect on wages because wage earners will gain more from the accompanying fall in income tax rates than they will lose from the introduction of the GST. The net effect of the tax changes will be to increase the disposable income of wage earners by more than the increase in their expenditure, as is evidenced by the fact that the package involves a cost to the budget.

Monetary policy is based on the view that inflation will be within the target immediately before the GST is introduced and that it will be back within the target a year later. This view in turn is based on the assumption that there will be no second round effects due to higher wage outcomes or opportunistic pricing behaviour as outlined above. If we start to observe behaviour that indicates that this assumption was not correct, then monetary policy would act upon it. We are not acting at present on the expectation that this assumption will be violated; we are acting on the expectation that it will hold.

I would like to conclude by saying a few things about Y2K. I think they are in order because their subject is very topical. There are now only 32 days to go to the new century, or the new millennium—whatever you want to call it. When I appeared before the committee in June, I said that Australian banks, building societies and credit unions were very well prepared for Y2K. They had not completed all their final testing at that stage but now they have, and everything is being done to make sure that their computer systems will be able to handle the change to the new century. This includes not only all their internal accounting and record keeping systems but also their ATM, EFTPOS and credit card systems. As well as making sure their systems are compliant, they have also been sending out very clear messages to their customers about the safety of their deposits. We are very pleased to see this because, as I said in June, the simple fact is that deposits are safe and records are not at risk from Y2K related problems.

I should also say a few words about my own institution. You will not be surprised to know that we have put a lot of effort into our own systems to make sure that they are Y2K compliant. One of our most important is our electronic direct entry system, which handles all of Australia's pension payments. You will be pleased to know that these payments will be made on time.

I mentioned last time that it is not just a matter of getting the technical side right, but that it is also important that we do not run into the problem of public overreaction. All the indications here are that the vast majority of the public is taking a sensible and calm approach and has not been influenced by alarmist stories or predictions of doom—not that there have been many of these, anyhow. In our judgment, the Australian media coverage, with only a few exceptions, has been accurate and balanced.

I am often asked by people whether they should take out extra cash to see them over the new year period. My advice is usually along the following lines: do not take the risk of having too much cash on your person or in your home. The safest place for your savings is in the financial institution that the savings are currently in. Do not fear that the country will run out of cash—we have printed enough notes to provide for any conceivable demand—and remember that you really are only dealing with a long weekend. Banks, building societies and credit unions will be open on the three days before New Year's Day, which is the Saturday, and will reopen on the Tuesday.

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

Because Australia and New Zealand will be the first countries to enter the new millennium, there will be a lot of international attention focused on us, including a fair bit of live television coverage to other countries about what is happening in Australia. You must remember that the United States will only be starting its working day on Friday when we cross over into the new millennium. I am confident that Australia will acquit itself well, once again, in the eyes of the world when the great day comes. I will conclude on that comment. Thank you, Mr Chairman.

CHAIR—Thank you very much, Mr Macfarlane. I understand copies of that opening address are available if anyone wants one.

We might start off by going straight to monetary policy, as you would expect. I refer you to the section in your semi-annual statement on market interest rates. When you look at graph No. 29 with the short-term interest rates of 90-day bank bills and 180-day bank bills you can see they are edging up significantly higher than the official rate of five per cent. Obviously they have been edging up, but they have jumped even more. Also, if you look at the 10-year bond yield, you can see that it is well above six per cent now. Over the page you can see the comparison between the cash rate and the 90-day bank bill rate. In each case you can see that they have increased significantly above what they were, notwithstanding the cup day increase. My question is: is there any way you could rule out another increase in the next six months?

Mr Macfarlane—I cannot really rule out anything—and never have been able to—but I would like to make a few comments on the behaviour of market interest rates, particularly now you have drawn our attention to these graphs in our semi-annual statement. If you look at graph 29, which is the first one you pointed us to, it shows that the 90-day rates had been predicting an increase in interest rates earlier than June. They were forecasting an interest rate increase for about five months before something happened. So the fact that they are forecasting something does not mean that it is ever going to happen, and it certainly does not mean that it is going to happen quickly.

If we turn over to the other graph that you drew attention to—graph 33—you can see that there was a period in the middle of 1998 where, for four or five months, the 90-day rates were well above the cash rate and were forecasting an increase in interest rates. That increase never happened. In fact, what did happen three or four months later was that interest rates actually went down. So the 90-day or the 180-day rates do contain a forecast of interest rates but they are not necessarily any more accurate than any other interest rate forecaster. Sometimes they get it right; sometimes they get it wrong. Often they get it right in the very long run but they get it wrong for a long time before they get it right.

CHAIR—Does that include the 10-year bond rate?

Mr Macfarlane—It is probably even more so with the 10-year bond rate because the 10-year bond rate in principle is reflecting the inflationary expectation and therefore, by implication, the interest rate expectation out for a good 10 years. So the 10-year bond rate is really not making a very immediate prediction about anything.

The other thing I should also mention is that the behaviour of interest rates in the second half of 1999 has been influenced by the Y2K effect. In all countries, short-term interest rates have tended to rise because of fears that there might be liquidity shortages over the century date change. So that is also built into those 90- and 180-day rates.

CHAIR—Does that mean that, following your expected successful transition over the Y2K period, we could actually see something slightly different again?

Mr Macfarlane—I think some of the rates like the 180-day rates have their little peak, and they are already coming down a bit. It does not mean they are coming back to five per cent, but they have a peak around the new century.

CHAIR—On this question of interest rates, you have alluded to it today and there has been quite a lot of publicity recently about the fact that Australia has two economies, one that seems to be dominated by the Sydney and probably Melbourne experiences and another one that is affecting other parts of the country. When you are trying to make these decisions, what balance do you put on the fact that on the one hand you have got the economy growing very well in Sydney and Melbourne but in other parts of Australia it is certainly not?

Mr Macfarlane—You are right to draw our attention to the fact that you can only have one monetary policy for the country, you cannot have one for individual regions. But, having said that, I think it is a bit of an oversimplification that, in its extreme forms, people say, 'Well, it is really only Sydney,' or sometimes they say, 'Oh, it is Sydney and Melbourne.' I think that is a severe oversimplification. There are a lot of other parts of the economy that are doing very well; there are a lot of other parts of the economy that are not doing very well. But if we look behind the figures, for example, if we look at a thing like employment growth, which is a very good indicator of how the economy is going, over the last year employment has grown by 2.2 per cent in Australia. It is true that it grew by more in New South Wales, but not by much—2.4 per cent; in Queensland, 2.3 per cent. In South Australia, which was starting from a low base, employment grew by 2.7 per cent.

If you look around at all these various indicators you will find that there are a lot of other parts of the country that are doing quite well, or certainly showing indications of strong economic activity. Another one that people look at is house prices. If we use the ABS series, it shows that over the year in Australia house prices went up by 5.8 per cent; New South Wales, 6.1 per cent; Victoria, 10.9 per cent; Western Australia, also 6.1 per cent.

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

CHAIR—We might come back to that one, but my colleagues are keen to start questions.

Mr WILTON—Mr Macfarlane, since your recent announcement stated that cash rates were raised to take policy to a less expansionary level, it is generally regarded that further tightening is likely. The implications of your words are that a five per cent rate remains expansionary. Is there a target rate that the bank would deem as neutral? How would you specifically describe monetary policy at present in terms of it being accommodative or neutral or whatever?

Mr Macfarlane—Everyone would like to know what the neutral stance of monetary policy was and what set of interest rates represents neutrality. I do not know of any country that has ever been able to nominate that. If you asked what level of interest rates represents neutrality on average over a couple of decades you might be able to get somewhere there. To say what level of interest rates represent neutrality today is much more difficult, particularly if someone then says that, having specified that number, that is where you should be and the story is over as we now know that neutrality has been reached. If you did attempt to define neutral, it would be neutral in light of the economic environment that you are in. If the economic environment that you are in changed over the next three months, you would then want to move your interest rates in line with that.

It does have some of the elements of a tautology. Wherever you are is where you think the right level of interest rates is, taking everything into account. That does not mean that is where you are going to stay forevermore, nor does it mean that you have somewhere locked away in a file a profile of interest rates which you are planning to introduce but you have not told anyone about. You are basically adjusting it as you see the economy unfold in front of you. As I said before, the main reason for that tightening was that we came to the conclusion that the most expansionary point in the downward phase of the interest rate cycle—the one that had taken us down to 4¾per cent—was more expansionary than you would want to have once you lost the external contractionary forces and returned to more broadly based even if not higher growth, where there was not a big risk of a contraction.

We are not saying, when we raise rates, that the economy has turned the corner and is rushing away—far from it. Literally it is not and it is growing more slowly in calendar 1999 than it was growing in calendar 1998 or calendar 1997. What we are saying is that the threat of a big contraction seems to have receded, so the balance of risks has changed. We do not have that threat to contend with. If you do not have that threat to contend with, you do not want to have a setting that is expansionary such as those you had particularly in 1998 and the first part of 1999.

Mr WILTON—Thanks. On a different tack, Treasury’s midyear economic and fiscal outlook says that, taking into consideration factors such as indirect taxes and income tax rates, there will be something of a modest fiscal stimulus in 2000 and 2001 of a quarter to a half per cent of GDP relative to those settings in 1999-2000. On the one hand, you have fiscal settings to boost the economy and, on the other hand, you have monetary policy settings doing just the opposite. Does that fiscal stimulus complicate the management of monetary policy? Does it make tightening more likely?

Mr Macfarlane—The fiscal stimulus has already been built into our forecasts—we know that. Most of that was apparent once the GST package was put together, so that is already in our forecasts. It would be a very big problem, I would think, if we had a forecast which showed that those growth rates, those 4½ per cent plus growth rates of 1997 and 1998, were accelerating.

But we have got to remember the profile of the forecasts we have for activity—and, as I said in the introduction, amazingly we were growing at over 4½ per cent—when we had this big threat of a contraction. That threat obviously did not materialise. We have now stepped down and through calendar 1999 our forecast, as I indicated to you, was 3½ per cent. We think that as we go through the financial year, it is going to be running about four-ish and picking up a little bit the following financial year, maybe 4¼ or something like that through the following financial year. And that includes the fiscal expansion. Our judgment is that with careful management the economy will be able to handle a development of that nature, that the economy is not overheating, not wanting to run away. It has stepped down a little cog, slowed down for a little while, and then it is moving back towards what should be a reasonable long-term growth rate.

That does not mean that that will define you a path of monetary policy, but it does indicate that if that outcome occurs it is unlikely that you would need to do anything drastic with monetary policy or that you would need to go for the brakes in a big way with monetary policy. That is the outcome we are looking at. It does not give an alarmist scenario for monetary policy.

Mr LATHAM—Could I just get a clarification on the first question asked by Mr Wilton? In your answer were you assuming that in the current circumstances the stance of monetary policy is expansionary?

Mr Macfarlane—I suppose I would have to fall back onto that tautology of saying that the stance of monetary policy at the moment is the right stance of monetary policy for the sort of outlook that we are looking at. It is accommodative. It is a stance of monetary policy which is not designed to try and pull the economy back. It is a stance of policy which allows the economy to grow at a fair rate.

Mr LATHAM—On a related matter, in your opening statement you made use of the term ‘pre-emptive’ in describing the rate increase at the beginning of the month. Is there something that you are trying to pre-empt other than the brighter international outlook?

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

Mr LATHAM—I suppose people looking at the decision objectively note that monetary policy is said to have a lag of about 18 months. The midpoint of that 18 is nine months which brings us to about June or July of next year. Is there something in the 0.5 per cent fiscal stimulus that needed to be pre-empted in the rate rise at the beginning of the month?

Mr Macfarlane—That econometric evidence which you are quoting—and which I have never had as much faith in as the econometricians who devised it—even if we take it at face value, that 18 months is the midpoint. Nine months is not the midpoint. The 18 months is the midpoint and that is a very long lag. You cannot pull a little scenario based on nine months, I am afraid.

Mr LATHAM—What about a scenario of capacity constraints in the economy? Mr Stevens in a recent speech said that he thought there was no evidence to show that the NAIRU was lower than 7.5 per cent unemployment. In your opening statement you have joined the Treasurer in forecasting that unemployment will fall below seven per cent. Is the bank taking that as a sign of capacity constraints and that the NAIRU will serve to increase inflation, or are you going to follow the United States practice of testing this proposition of a lower NAIRU before acting?

Mr Macfarlane—Before I hand over to Mr Stevens, I just want to say that when he said there is no evidence that the NAIRU was lower he was merely making that point. There is no evidence yet. You do not know unless it has been tested. We cannot assume it. But you will know after it has been tested, and the best way of running things is to test things reasonably carefully rather than immediately assuming something.

Mr Stevens—It is probably worth clarifying what I did say. Those remarks were made in the context of talking about the US economy where there were old estimates, if you like, of NAIRUs which were six per cent, 5½ per cent—something like that. They have actually experienced the experiment of having unemployment go below that number, and wages growth has actually picked up a bit in the US but not to the extent that some of the old NAIRU models would have suggested. My comment was simply that there are good reasons to suspect that the NAIRU, if it exists, and assuming that it is a sensible framework—and I would have to say that I think the policy makers have their reservations about that—may have fallen. But my point was simply that we have not had the US experiment yet. We will, I think, in the next year or two, but we have not done it yet and so you cannot be sure—that was all.

Mr LATHAM—Just one other point on capacity constraints: the semi-annual statement talks about emerging skill shortages and they, of course, are normally followed by wage pressure. Are there other capacity constraints that the bank is concerned about and which may have an influence on the stance of monetary policy? If so, can you quantify such constraints and the extent of the output gap?

Mr Macfarlane—I cannot think of any off the top of my head at the moment other than there is always capacity for constraints for particular skills. Maybe there is not always. In a recession maybe there is not, but most of the time there will be some skills shortages where there is the usual amount of advertising and people having trouble filling positions and trying to bring in skills from other countries. I have not got any other concrete examples.

Mr Stevens—We made some reference to capacity utilisation measures in surveys that are in the statement in graph 20. They do not, I think, say that the economy has reached some capacity constraint now that is binding on us. But they do simply say that capacity utilisation, as businesses report it, has gone up over the past couple of years. I suspect that there are some local areas of capacity problems—say, it is pretty hard to get a tradesman in Sydney at the moment—and there is some pressure in that side of things, in the building side. That is certainly not across the country and we are not suggesting that capacity constraints are being reached on a widespread basis. There are just a few areas and that is probably the clearest one where there are some reports of those things.

Mr LATHAM—But in saying that monetary policy has entered a new phase, are you saying that capacity constraints are now a bigger issue than they have been in the past, and will remain an issue for the foreseeable future?

Mr Macfarlane—No, I do not think so. When I say monetary policy is going to enter a new phase, the old phase was when you actually waited until you had the capacity constraints upon you before you tightened monetary policy. What we are saying is we would tighten earlier. If you do that and you do it successfully, you do not have periods where things are running far too fast for the capacity that is available, where you have big inflationary pressures building up and then you have to put the brakes on quite hard. Our view of the new approach to monetary policy is that you avoid those excesses.

If you want to lengthen the expansion you have got to try to avoid periods where you have excesses or imbalances that are going to threaten it. One way of doing that, on the basis of our judgment of the past history of monetary policy, is to tighten a bit earlier and in all likelihood you will have to tighten by less than you would if you had followed the old model. If it works out successfully you will have less periods of clear overheating and excess. The corollary to those periods of overheating and excess, where inflation goes up and where asset prices go up and where you have investment booms where people build far more than they need, is the recessions that follow them. The more you can avoid those periods of excess the more likelihood you will have of having a longer expansion and having periods where the periods of weakness are slowdowns rather than recessions.

Mr PYNE—Mr Macfarlane, in your opening statement you talked about Y2K for the first time that I can remember at one of these discussions. You are obviously confident that the Australian financial institutions and corporate businesses have got on top of the Y2K issue. Do you have any impressions on whether some of our Asian neighbours are as successfully on top of Y2K, in particular with respect to China?

Mr Macfarlane—First of all let me say I did actually speak about Y2K in June.

Mr PYNE—I was not here in June.

Mr Macfarlane—Secondly, you are right to say that a number of other countries in the Asian region have almost certainly not reached the degree of preparedness that we have. Australia is really up there in the three or four countries that have reached a very high degree of preparedness. A number of other countries in the region have not and they may well have problems. But I think the important thing from our perspective is that problems that happen in China, Indonesia, Malaysia or wherever, whilst they will be annoying, are not actually going to affect how we behave in Australia when the clock ticks over into the new millennium. There may be some exporters who might find they get their money back a little later than they thought. There might be some delays but these are nagging little problems that would probably go on during January and February.

But in terms of how we make the transition on the night, I do not think the weaknesses in other countries are going to have any impact on us at all, particularly since most of the businesses here will have made sure that they are not going to be dependent on receiving something. They are not going to be getting anything over that period anyhow but if they were worried about receiving money or something from these countries they would have made sure by now that they were either going to get it well before 1 January or well after 1 January. There might be some sorts of nagging irritations that are caused by this but it is not going to impact on our economy in that crucial period, the couple of days running up to the new year or the first couple of days after the new year.

CHAIR—We will keep going on monetary policy at the moment. We will come back to Y2K.

Mr PYNE—Okay.

Ms GAMBARO—Mr Macfarlane, I want to speak to you about the official interest rates and the increase of 0.25 per cent. We seem to be following the US trend—they had a similar increase in August. There are people who would suggest that there has been some sort of correlation between the increase in our rates and the US rates. Is that so, or what factors come into play here? Do we tend to have a copycat mentality?

Mr Macfarlane—No—

Ms GAMBARO—Was it just coincidental?

Mr Macfarlane—I would resist that one strongly. If you look over longish periods, like whole business cycles, there is a world business cycle. There was this period, as I said, when everyone thought 1999 was going to be the really tough year; it was going to be worse than 1998. Then, as we went through that, people woke up that, no, it was not. It has not turned out as bad as we thought. Asia is recovering, Europe is growing stronger than we thought, even Japan looks like it is recovering—1999 is going to be a better year than 1998, and 2000 will be stronger. That sort of realisation occurred in all countries as we went through 1999. So countries—not all countries, but I gave a long list of them—at some point along there made up their mind, when they thought it was time, to take off that very accommodative monetary policy stance they had and try and move towards something that was more normal.

There is some commonality between all countries. On the other hand, if you tried to make a living by simply assuming that Australia moved interest rates at the same time as the US, you would lose a lot of money. Let us run through the last three years. Let us go back to 1997. In March 1997 the US raised interest rates. What did we do during the remainder of 1997? We put interest rates down twice, once in May and then once in July. Then we go to 1998. What happened in 1998? In the middle of 1998, the US had put interest rates down three times and we had done nothing. Right at the end, in December, we put interest rates down by a quarter. Some people would say, ‘Look, you followed the US.’ They put interest rates down three times in a great hurry and we came along, at a very leisurely pace, and put them down once. The same thing as we went into 1999: as soon as it became clear that the US looked as though they were going to put interest rates up—people were thinking this in May and I think they put them up for the first time in June—a lot of people said, ‘Oh, Australian rates are going to go up.’ They did eventually, but the US had already done it a couple of times before we were convinced from our perspective.

One of the reasons, of course, that we were a bit slower and we did it by a smaller amount is because we did not put them down as much in 1998 as the US did. The US put interest rates down three times very quickly in the third quarter of 1998 because they were worried about the international financial market seizing up and the American financial market seizing up and they acted in a very big way—some people would say overreacted. I would not say that, but some people would say they acted very precipitously. We did not; we did it in a rather considered way. So if you look over that period there is some similarity, but the similarity is caused by the underlying world cycle. In terms of timing, of the amount that we went, they are very different.

CHAIR—You were talking about excesses and overheating and so on. What sort of growth rate would you have anticipated if you had not put interest rates up at the beginning of this month?

Mr Macfarlane—Our models are not so sophisticated that we can really trace through such an effect as small as that which particularly is going to have an effect over a longish period. The growth rate would be somewhat higher, but it is very hard to quantify. I am sorry, I really cannot do that, other than to say that it would be higher and you would be taking risks that things could speed up quite a lot. It would have sent a signal, too, if we had done nothing and everyone else around the world was saying, ‘Look, we think the world cycle has changed, expansionary forces are now predominant,’ and we said, ‘No, we do not think so.’ I think that would have sent quite a big signal. So, as well as just a purely physical effect, there would have been quite a big psychological message that would have come out which would not have been a helpful message.

CHAIR—So you are saying that the decision to go then was a psychological message as much as anything else?

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

Mr WILTON—It has been said more than once recently that you do not need to tighten monetary policy as much today as you did, say, in 1994, to get the same effect. What does that mean? How has it occurred? Is it indicative of the fact that households may be more leveraged now than they were at that time?

Mr Macfarlane—There are about five questions there, but I will work my way through them. Yes, indeed, it has been said—in fact, I was one of the people who have said it—that once you reach a low inflation environment, essentially, the movement in interest rates required to achieve any particular outcome should be a good deal smaller than the movement in interest rates which was required previously. So in the high inflation environment of the seventies or eighties, a movement in interest rates of 700 basis points was not out of the question, in a tightening. In 1994, when we had half adjusted to a low inflation environment—maybe more than half—the tightening there was 275 basis points. I have indicated that this time around it would be very surprising and disappointing if the outcome was not a good deal lower again. That is the first thing. I think it is really mainly a function of a low inflation environment. What is required to keep inflation low in a low inflation environment is a much lighter touch than was needed to get inflation down.

You drew attention to another possible explanation in addition to the low inflation environment—that is, the fact that the household sector is now carrying more debt. Of course, that in itself is actually partly a result of a low inflation environment, because with low inflation you have low interest rates; with low interest rates households can service much more debt than they could in earlier eras. So in some senses it is an additional explanation; in some senses it is simply a corollary of the first explanation. I have said in the past that I think there is something in that argument and that the transmission mechanism would be different now that households have a lot more debt than previously. It would mean that you have to be a little bit lighter on the touch than you would have been in earlier periods. So both those things reinforce each other.

Mr WILTON—Recently, Assistant Governor Stevens made a speech in which he said that the tightenings that occurred in 1994 were probably the most important for two decades. Do you agree with that statement? How do you interpret it?

Mr Macfarlane—Did you say, Glenn, that they were the most important for two decades?

Mr Stevens—One of the most important.

Mr Macfarlane—I have spoken on this subject as well. I think that was a very successful application of monetary policy in that it was not quite as pre-emptive as this one. Some overheating had started and there was wage pressure, which there is not currently. But it was very successful in that it slowed down an economy which was growing very fast and with wage pressure. But it did not create a recession; it slowed it down to a growth rate of about three per cent or so, which was below potential.

Some people were disappointed that growth was as low as that, but it was an extremely small price to pay. Given that it stopped those inflationary pressures, we were able to ease off again in the middle of 1996, which was, as it turns out, just the right time to be easing off, given the developments that occurred in the rest of the world. We are now in the ninth year of an expansion. I would certainly regard it as being a very successful example of monetary policy—not perfect, but still very successful.

Mr WILTON—In summary then, would you say that those monetary actions of 1994 were a case of the RBA allowing the economy only five minutes of economic sunshine, or was it just plain, good monetary policy?

Mr Macfarlane—Certainly the latter and not the former.

CHAIR—Mr Macfarlane, I want to take up a point in your first answer to Mr Wilton a minute ago. You were talking about the need for a lighter touch because of the level of household debt. Does that mean you have fears that, if you were to move interest rates up a bit more, you could snuff out consumer confidence and consumer spending?

Mr Macfarlane—I do not say that we have fears. It is something that we would take into account. My feeling so far is that the evidence is that consumer confidence has not been sensitive to what has happened. It has actually risen since the tightening in early November. I think it is a medium-term factor, but it is not such a delicate flower that it is going to get snuffed out very quickly.

CHAIR—But, equally, household debt is much higher and has gone up quite significantly recently, and therefore any interest rate move will have a much bigger impact.

Mr Macfarlane—Yes, it would have a bigger impact. But, when we talk about household debt, there is a number of ways of measuring it. We have probably been as guilty as others of measuring it in a way which probably makes it look a little more alarmist than it is, because we have looked at the level of household debt, which is a stock, and compared it to a flow, which is household income. I think a financial expert who is looking at a household or a business would probably look at something else. They would look at the stock of debt compared to the stock of assets and, as well as the value of the debt going up, the value of the assets has gone up quite a lot. If you look at it that way, it is true that debt has risen, but not by anywhere near as much. It has gone up from 10 per cent of the value of household assets to 13 per cent. So if you looked at the two stock figures against each other, you would get a bit of a sign of an increase, but nothing particularly alarming.

The other way of looking at it would be to look at the flows—which we have done in the semi-annual statement—where you look at the amounts that you have to pay each year to service your debt and you compare that to household income. So you are comparing a flow with a flow. If you look at graph 16, on page 17—the right-hand panel there—it is about six per cent. At one stage, it has been as high as nine per cent and it has been as low as five per cent. Of course, that would go up if interest rates go up. But it is hard to conceive of how that could get back to the sorts of levels that it was in 1989-90. The panel on the left is the one that I am saying probably overstates and makes the rise in household debt look a bit too dramatic.

Mr PYNE—So, in fact, Mr Macfarlane, you are less concerned about household debt than perhaps some of the people in the public world who have been trying to talk up the problems with respect to household debt. Do you also think the consumer confidence might be explained by the fact that they inherently know household debt is not a concern to them as long as the value of their assets is increasing commensurate with the value of their debt?

Mr Macfarlane—Yes, I do not know where to put myself in the spectrum of concern about household debt. I am certainly not on the alarmist wing. Household debt is something we look at—and, as I said, I think we should have another graph there in terms of just the assets side, comparing the stock of debt to assets—in judging the stance of monetary policy. If households are out there borrowing very quickly, that indicates to us that both the cost and the availability of credit are very conducive to borrowing. In other words, that is one of the things you look at when you make a judgment about how expansionary or otherwise monetary policy is. So we certainly look at these things; we look at household borrowings.

I would have to say that, if you judge household confidence or sentiment by their borrowing, they are still borrowing at a fair clip. In fact, the growth rate is a little higher than it was when I was here last time in June. I think it has gone up from 15 per cent to 17 per cent or something. So we look at it and it figures in our assessment of the economy—directly, really, through our assessment of monetary conditions—and it certainly is factored into our judgment of how the transmission mechanism works, which leads to this argument that you have to be a little lighter on the touch than you would have been before. But, as to whether it is going to cause financial distress on a large scale, I would not be in the alarmist school there. There will be some households which obviously have gone too far—there always are—but I do not think I would be in the alarmist school.

Mr LATHAM—Do you think there is a possibility that your lighter touch is being negated by the booming wealth effects that you point to in the semi-annual statement?

Mr Macfarlane—I think wealth effects have played a role in that strong growth of the economy during the period when we had the contractionary external effects working on it. I think the wealth effects in Australia are unusual. They are not the wealth effects that have happened in the US. The wealth effects that have happened in the US are just through a stock market that has absolutely boomed. Our stock market has not boomed in anywhere near the way the US stock market has boomed. It has gone up but it has behaved itself in a manner which has been quite exemplary from a central banking point of view. I do not see any sign of a bubble or anything in the Australian stock market, whereas a lot of people see that in the US stock market.

What has happened in Australia, which is a bit different from other countries, is that both demutualisations which seem to have created household wealth out of nowhere—it is not really out of nowhere, but from a household sector perception it seems that way—plus some privatisations where the share prices have subsequently risen quite a lot, have increased household wealth. I think that those increases in household wealth—or perceptions of household wealth—are more enduring than an increase in household wealth which was simply based on a boom in the stock market.

So the answer is yes: when we are looking back the increases in wealth have been an important factor. But I do not think it is the sort of wealth that is going to run the risk of evaporating the way an increase in wealth based simply on a booming stock market would.

Mr LATHAM—How is Australia different? What is the wealth effect here if it is not off the stock market?

Mr Macfarlane—I am saying that it is, but it is due not to the existing number of stocks or newly created speculative ones rising; it is due to these demutualisations and privatisations of very substantial businesses. So it certainly has increased wealth, but I am saying I think it has increased wealth in a less volatile way than the way it has happened in the US.

Mr LATHAM—How do you view the increase in consumer confidence which followed the rate rise on 3 November? Is that cause for concern or a sign that the lighter touch needs to be a bit heavier?

Mr Macfarlane—I do not know. I think I would probably have a lot more questions to answer if consumer confidence had fallen sharply after that rise in interest rates in November. They actually only went up a tiny bit, but to all intents and purposes it has been stable. One way of viewing it is that the consumers think that it was a very sensible, pre-emptive move, and it has increased the probability of sustainable expansion.

Mr LATHAM—That is what they are saying in my electorate up and down the street. The point about pre-emptive monetary policy is that obviously it relies on very good forecasting. Is there a concern in the bank that your forecasting of the imminent slowdown has been a bit late in coming? In fact, it has not come at all. For instance, on page 3 of your opening statement you say ‘there was a similar expectation of weakness in 1999 which did not come to pass’. I have sat here for many past hearings, hearing of the imminent slowdown which is yet to come. Is it a worry that in your forecasting capacity there has been an error in recent times and that it makes the risk of the ultra pre-emptive approach a bit higher?

Mr Macfarlane—You have pointed out some of the difficulties involved in conducting this approach to monetary policy, but every approach to monetary policy has got difficulties and we think this is the best available. You are right that we have forecast a slowdown for some time and it took a long time to come. The great irony is that it came after the Asian threat passed rather than whilst the Asian crisis threat was upon us. But I think in the broad sweep of history forecast errors of that size are actually quite small. Assuming that your four per cent is going to go to three per cent and it does not happen and you stay at four per cent is a relatively small error by the standards of most economic forecasting over the period that I have been familiar with it. It is also true that inflation stayed below the band for longer than we thought, but now that is not the case. In fact, in some sense what has happened is that the deviations have not been all that large and the forecast errors have not been all that large, but what we were forecasting did eventually come to pass. It is not as though we were forecasting something which never occurred or that we were forecasting the economy was going to go one way and it clearly went the other way with a vengeance. My feeling is that, over the past two or three years, the forecasting record has been not brilliant but better than average by the standards of economic forecasting.

Mr PYNE—Mr Governor, you forecast a slowdown and a slowdown did occur—unlike other central banks which made forecasts which acted in an opposite fashion to the way they should have acted. So we should be congratulating the Governor.

Mr LATHAM—Yes, but that is not what the Governor said in his opening statement. He said, ‘A similar expectation of weakness in 1999 did not come to pass. Real GDP grew by over four per cent in the 12 months to the June quarter and will probably still be showing a similar rate in the 12 months to the September quarter.’ So let us praise reality.

CHAIR—Mr Macfarlane, I will take you back to comments by Mr Latham. You were talking about Wall Street. In the context that it is quite common now for Australians to leverage their household assets to buy shares and so on, if the bubble bursts in Wall Street—a lot of people expect it to—what effect will this have on household leveraging but, more importantly, on consumer confidence? Have you factored that in? It seems to me that could have a very significant effect on the economy.

Mr Macfarlane—We have been living for quite a while with the possibility that Wall Street could collapse. It has not happened. We have had a couple of occasions in the last three years where Wall Street has actually gone down by 20 per cent. When you say that people are surprised, they did not notice it but it happened on two occasions—once in 1997 and once in 1998. We could have a massive fall in Wall Street. I do not put a high probability on that and, even if it did happen, it is not clear that its economic effects would be as catastrophic as a lot of people assume. If we go back to 1987 when we had a very sharp fall—22 per cent in one day on Wall Street—a lot of people were thinking the end of the world was nigh. That did not happen. In fact, 1988 turned out to be quite a strong year for the world economy.

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

CHAIR—Can I take your comments that following the 1988 experience you have been taking appropriate responses to mean that you would have to ease interest rates if that did occur?

Mr Macfarlane—If there were to be a collapse in Wall Street and a collapse in share markets around the world one would presume—I do not know; I cannot say for certain—that that would come to the forefront of your thinking.

Mrs HULL—I am sorry to come back to the household sector, but it is of concern to me that we have a highly indebted household sector. We also have rapidly increasing net worth within the household sector. We have spoken of measuring these areas, but I do not hear any mention of how you are going to manage them. It appears to me that at the moment there is a lack of management strategies as to how we manage this fairly delicate situation.

Mr Macfarlane—We cannot manage household debt. Households are supposed to manage household debt, not central banks. It is a bit like the regional question. People say, ‘You’ve got such and such a monetary policy but it’s not suitable for this region or that region.’ I think it is the same thing when we look at the economy more generally. There are businesses, there are households, and all sorts of expenditure is going on. You have to choose a monetary policy which is, on average, the right one for the country. There might be some parts of the country where people are expanding too fast and some parts where they are not expanding fast enough. There may be some business or household entities which are running overstretched balance sheets. There are other parts that are not. All we can do with monetary policy is come up with the right policy on average for the country.

As I say, we take into account what is happening when we judge the stance of monetary policy, and we have taken into account that households have, on average, been keen to borrow. Their judgment is that credit is cheap and freely available compared with most of their experience and so they are borrowing a lot. That helps us come to an assessment about what the appropriate stance of monetary policy was. But it is very difficult then to do anything about what you refer to as 'managing' these household balance sheets. The households are meant to manage the household balance sheets, and we are meant to run monetary policy in a way which does not make it difficult for them.

If you ran a monetary policy which allowed a massive boom in asset prices to develop and you saw a huge amount of gearing up margin lending to capitalise on these asset prices, I think monetary policy could be accused of making life very difficult for the household sector to manage its balance sheets. But I do not think we have. I think we have run monetary policy in a way where a prudent household is in a good position to manage its balance sheet. If some choose to be imprudent, that can cause a lot of distress to individuals. But I do not know what we can do to prevent that happening, just as a lot of the household distress may be caused by gambling, divorce or all sorts of things. It is upsetting, but I do not know what we can do about it with monetary policy. One thing we could do is to put up interest rates by a huge amount and that might stop the appetite for borrowing. But I am not sure that is what you have in mind.

CHAIR—Did you want to follow that question up?

Mrs HULL—No, thank you.

CHAIR—We will take a short break.

Proceedings suspended from 11.21 a.m. to 11.36 a.m.

Resolved (on motion by **Mr Pyne**, seconded by **Mr Latham**)

That the committee authorises that submission No 1 from the Reserve Bank of Australia be accepted as evidence and authorised for publication as part of the committee's inquiry.

CHAIR—Mr Macfarlane, on this question of the interest rate increase, as we discussed earlier there are indications with things like the 10-year bond rate that the longer term expectation is for higher interest rates. By keeping that rise to just 0.25 per cent is this keeping the value of the Australian dollar down, which in turn has a positive effect on our balance of trade and is trying to keep that aspect of it balanced while at the same time allowing the market to sense that longer term there will be another increase in interest rates?

Mr Macfarlane—I do not think the issue of the Australian dollar really featured at all in the decision on monetary policy on the grounds that it has behaved in a pretty standard manner in 1999. It certainly did some very strange things in 1998. Since it recovered from the events of August to September 1998 the Australian dollar has chugged along rather unobtrusively and done its job. It has not really figured in any significant way at all in our monetary policy decision making.

Mr LATHAM—Just in terms of industry reaction to the rate rise, I saw that the head of one of those special pleading, rent seeking industry groups—I think it was the ACCI—described your increase as economic vandalism. I think that is an alarmist description and one that does no service to the organisation he represents. Do you think there needs to be an improved level of maturity in the business community in understanding the very pre-emptive nature of these rate increases and the strategy upon which you have embarked?

Mr Macfarlane—My overall impression of the response to the rate increase was that almost without exception—you mentioned one exception—people handled it very sensibly. I think thoughtful people recognised that policy had been quite expansionary. It had done its job and it was really a matter of time before some sort of adjustment was made. My judgment is that the usual cast of lobbyists who rush to get their names in the paper at this particular time behaved very sensibly, with one exception.

Mr LATHAM—Could I turn attention to fiscal policy. In federal politics, the budgetary position has been quite an issue in recent times. Objectively, the forecast of a cash surplus of just $500 million for 2000-01 out of a $160 billion budget at the end of a 10-year growth period is a wafer-thin surplus. How much pressure is the deterioration in the federal budgetary position placing on monetary policy?

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

The second part of your question is: given that we are in the ninth year of an expansion and we had big deficits in the early years, shouldn't you be counterbalancing this with big surpluses in the later years of an expansion? The answer is: yes, in principle, I think you should. But things do not always work out that way. There are a number of things that have come up that have proved to be more expensive than might have been thought at the beginning or new things that have arrived on the horizon. I think the evidence in other countries is that, even though it is possible to run large budget deficits for a time, it seems to be rather difficult to run large surpluses for any length of time. The democratic process is such that people say, 'Why are you taking all these taxes off me if you don't even need to spend them?'

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

Mr LATHAM—Given that the principle of big budget surpluses is not being upheld and new things are on the horizon, would the bank prefer that one of those new things—the tax cuts associated with the GST—was paid at a different part of the economic cycle or was not paid as substantially as has been legislated?

Mr Macfarlane—We cannot really hope to overturn the democratic institution of parliament which came up with that result.

Mr LATHAM—But if you had macroeconomic advice for the government, as the bank inevitably must have—

Mr Macfarlane—If we were a dictator, we might do things differently, but we are not.

Mr LATHAM—Do you support the submission by the Business Council of Australia, which received some prominence recently, about greater independence in the setting of fiscal policy—independence from the democratic process, the vagaries of which you have described, along the lines of the emerging independence that we have had for the Reserve Bank itself? The BCA was talking about a mechanism which allowed more sensitive finetuning of macroeconomic policy that can be achieved either under the current fiscal arrangements or by monetary policy, given the lags in your instrument?

Mr Macfarlane—I applaud them for the sort of lateral thinking that they are doing, where they are looking at things in a fresh light and in a very responsible manner. I could certainly imagine circumstances where I would like an arrangement like that to be in place. I could certainly imagine circumstances—although we are not in them at the moment—where using fiscal policy to damp down an economy could be quite helpful.

On the other hand, it is a very big step to take fiscal policy—the taxation system—out of the democratic processes. It is much bigger than taking monetary policy out. Monetary policy does not have the distributional consequences that fiscal policy has, and I think it would be a very big step. Although, I, in principle, have no objection to it, I cannot imagine that a democratic society would be able to handle that as comfortably as they can with monetary policy. Because remember, independent monetary policy is really delegated to us. It can be taken away again if we do not handle it properly.

Mr LATHAM—We see you as part of the democratic process, given the fact that we control the legislation covering your operations. Surely it can be part of the democratic process for the same arrangements to cover fiscal policy, no more or less democratic than the proceedings that we have here today.

CHAIR—You mean the tax office takes over?

Mr LATHAM—I am just putting the proposition that this is not an undemocratic move and it may actually help economic outcomes in this country.

Mr Macfarlane—I am not saying that it is undemocratic. I am saying that it would be difficult for a parliament to give that away.

Mr LATHAM—Finally on the budgetary position, on 17 November the *Financial Review*, which is normally a very reliable newspaper, reported:

The Federal Government has asked the Reserve Bank of Australia to delay paying nearly $700 million of its full-year dividend until 2000-01, when Treasury faces a possible Budget deficit.

Have you received such a request? How have you responded, and do you believe that such requests damage the perception of the bank's independence and credibility in the market?

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

My feeling is that, if we had the time and energy, there is a case for devising a method of calculating the Reserve Bank's profits that smooths it completely so you do not have these big jumps from year to year which make the task of fiscal policy more difficult. We have not yet devised a way of doing that, but this is a small step in that direction.

Mr LATHAM—Have you been working on that device?

Mr Macfarlane—I have given it some thought and I have looked at it. I have had discussions and it is a rather difficult thing to do.

Mr WILTON—In your statement you do dwell at length on household consumption given by both income growth and wealth. Regarding wealth, the bank has cited the demutualisation of the AMP and the capital flows generating from the sale of the first tranche of Telstra. Why didn't the bank then use this analysis to project forward the impact of consumption on the demutualisation next year and the impact of the capital gains tax rate reduction? Finally, wouldn't they add to growth and place even further pressure on monetary policy all in 2000-2001 being the year of fiscal loosening?

Mr Macfarlane—What is the demutualisation? Is it next year that you are referring to?

Mr WILTON—The NRMA. I beg your pardon.

Mr Macfarlane—I do not think NRMA is on anywhere near the scale of the AMP. I cannot rule out the fact that your people have not actually done some of that.

Mr Stevens—We have not built things into our forecast for NRMA. Ian is correct that it is not on the same scale as the AMP. In recent times there have been plenty of other things driving wealth along that seem to me to have been a bit more important. We did not see that the NRMA one, in particular, was something that we should pontificate about at this point.

CHAIR—Mr Macfarlane, you made a reference in your opening statement that you have assumed there would be no second round effects due to higher wage outcomes affecting monetary policy. On the question of wages, we have already seen that the corporate sector is paying some rather hefty salary increases to its senior executives, and we also understand there is a bit of a push being developed by the metal workers on wages. My question is: have you taken this into account and are you confident that the example being set by some of the higher salaried executives coupled with this may, in fact, force you to revise this wage growth expectation?

Mr Macfarlane—I am not really sure what is happening with executive salaries. The only systematic measure of executive salaries—which is a very broad one and includes executives in general, not just the senior ones—shows growth of executive salaries of about five per cent. That is a Mercer Cullen Egan Dell survey. There was a survey carried out by one of the newspapers recently which covered chief executives. The increases there were much higher than that. They were over 20 per cent.

I do not know that I have ever really understood the economics behind the setting of chief executives' salaries. It seems to me that it is more akin to the behaviour of sports people and entertainers. I certainly cannot understand why they have to go up by over 20 per cent. Maybe someone can enlighten me at some future time. I think that particular survey, which was the one that appeared to be alarming, actually covered a very small number of people. I think the broader ones are nowhere near as alarming as that.

On wages in general rather than executive salaries, all the indicators we have on wages have shown growth at reasonable rates in the three to four per cent range. So, as of this moment, you would have to say that wages are not presenting a threat, but there have been reports of particular areas, particularly the metal unions in Melbourne, which indicate that there are some unions in manufacturing who are aspiring to increases that would be far too high, given our inflationary outlook. My feeling is that I do not know whether these things are going to come to pass, but if they do come to pass, I think it will be very difficult for employment levels in the manufacturing industry in those areas if that were to happen.

Mr WILTON—I take it you would have some broad assessment of the AWU's activities in Victoria? I take it that you have also assessed the inflationary impact of the ACTU's $24 a week living wage claim. It seems that you have no formal or bank based view on the impact of these massive executive salary rises. In your view, what do they say firstly about management practices in Australia? What is your view on the possibility of those massive rises for share options and other means breeding resentment amongst the workers of Australia with a view to them ultimately following the examples of their bosses?

Mr Macfarlane—I have some sympathy with your line of questioning. I think that it will make it difficult for some companies to expect responsible outcomes for wages if their boss has just had some massive increase, particularly if it is not well-related to the profitability of the business concerned. I can see some tensions building up there.

Mr WILTON—Do executive salaries feed into higher cost structures or, in your view, are they exogenous to that?

Mr Macfarlane—You would have to look at the whole structure of the firm. Obviously that is one cost element. There may be a whole lot of cost elements going the other way. In some cases a big component of the salary might be share options. There might be—as is often the case—a smaller number of executives earning higher salaries, so the executive bill may not have gone up.

Mr WILTON—Why would the RBA be concerned about a supply side shock like oil prices, yet seemingly be relatively unconcerned about blow-outs in executive salaries?

Mr Macfarlane—It is not clear to me that we are concerned about the supply side shock of oil prices. We have seen oil prices recover from the falls that occurred last year and that is factored into our forecast. We are not sitting there worrying about it and calling it a supply side shock. Even if we were, one of the differences between those two things is the order of magnitude. If the oil price was to double as it has, that could have a much bigger impact on the economy. I do not know how many people were in this survey. I think it was 100 people's salaries.

Mr LATHAM—On wages, and in particular the second round impact from the GST, how worried are you about the problem of imperfect knowledge? The surveys are showing up that a lot of workers and trade unions are expecting the inflationary impact of the GST to be 10 per cent—the actual tax rate—rather than the two or three per cent that others are forecasting.

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

Mr LATHAM—In your opening statement you mentioned that you are working on the assumption there will be no second or third round effects. In the semi-annual statement, towards the end, it is projected that:

> It is unclear at this stage whether expectations of higher inflation might persist beyond the period of the GST's impact, and to what extent they might serves as a basis for price and wage decisions. This is an area which will require close monitoring over the year ahead.

How strong is the risk that your assumption given this morning in the opening statement will not hold?

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

Mr LATHAM—You would be aware of concern and criticism around the financial markets that this particular risk—the risk of second or third round effects from the GST—

was not mentioned in your statement on 3 November announcing the increase in the cash rate. Do you regret not mentioning that?

Mr Macfarlane—No. As I said in my introductory statement, that was not the reason for the tightening of monetary policy. It would have been incorrect to have put that in the statement on 3 November.

Mr LATHAM—You are not concerned by criticism of the bank's independence being in doubt because of this omission?

Mr Macfarlane—No, not at all.

Mr PYNE—With respect to the price effects of the GST which you have just been discussing with Mr Latham, do you think that the government's measures to try and avoid profiteering with respect to price increases are adequate, and the powers that they have given to the ACCC and others to pursue profiteering, or would you do something different to what we have done?

Mr Macfarlane—I do not know that I can answer that in a way that will shed a lot more light, other than to say I think it was important that there be some monitoring process to check that opportunistic pricing does not occur, and the ACCC is the obvious body to do that. So I agree with the decision, but I do not know enough about it to be able to recommend any better procedures or any improvements.

Mr WILTON—What is the RBA's estimate of the rise in the wage safety net required to maintain a real rise in wages?

Mr Macfarlane—The rise required to maintain a real rise would be a rise roughly equal to the rate of inflation that we forecast.

Mr WILTON—Given your concern with employment and labour costs, isn't it an important calculation for the RBA to have a definitive view on, or is that the RBA's definitive view?

Mr Macfarlane—I think that one is a truism. The rise in wages that preserves the real income is a rise equal to the rate of inflation. I do not know if you want me to answer a different question about what rise should be granted. I would be reluctant to do that, because I would then be trying to usurp the role of the Industrial Relations Commission.

Ms GAMBARO—I would like to ask you about business investment. There was a rapid decline in 1998. At the time you spoke about it you said there was a flat spot in overall investment. What is the current situation with business investment? Are there any signs that there will be a recovery in the business sector, particularly with investment?

Mr Macfarlane—Business investment has flattened out and it flattened out really towards the middle of 1998. Some people are very disappointed in that, but I am not. If you look over the whole expansion that we have been through, business investment has grown very strongly. In fact, there have been periods where business investment was growing fast;

periods where, on a 12-month basis, it has been growing in double digits for two or three years, even faster at some stages.

There have been periods where you would have to wonder whether there was not a risk of putting in place over capacity, which often happens in the mature phase of an expansion. You get an investment boom and you actually build too much, and so you end up with empty buildings and lines of production that have not got anything to produce. Then you get the reaction the other way. So the fact that we have had a pause in this big investment expansion I do not think has been any bad thing at all. As you have read, it has been generally flat for a year or 18 months, depending how you measure it.

What is the outlook over the next 12 months? Our guess is small positive growth, a two or three per cent increase over that period. It is not worrying me that we have not got back to these really rapid increases in investment. I think we will. In fact, I think it will probably be seen almost as a bit of a blessing that we had a pause for a while. The main indicator of investment, the Capex survey, for a while was showing downward revisions each time they had the survey. The last two times they have had the survey they have actually shown an upward revision. So I think we are gradually moving back up to, as I said, small positive growth and investment.

Ms GAMBARO—Is there a monetary figure or is there a range that is an optimum level for business investment, or again is that just subjective?

Mr Macfarlane—There probably is, but the problem with investment is it tends not to go smoothly. I have got some figures in front of me here for the 12 months ended growth in investment, and you can go back and you can find periods from March 1996 to March 1998—that is, two years—when it never got into single figures. It was always in double figures, with some of the growth rates 13 per cent, 17 per cent, 11 per cent. If you go back to early parts of the expansion, we have had periods where investment has grown by 20 per cent in a year. So we have had plenty of investment in this expansion, and it was just a matter of time, I think, before it flattened out, and that is what is happening now.

CHAIR—Mr Macfarlane, I might just move on to the paper that you have given the committee on bank fees on small business. First of all, thank you very much for doing that work for us. The question I would like to ask you, though, is are you concerned about the fact that it would appear from your work in this paper that fees to small business are in fact increasing faster than fees to big business?

Mr Macfarlane—Where have we got that?

CHAIR—That is on page 4.

Mr Macfarlane—We have got one year—we have got data for 1998 and 1997. Fees to households have risen faster than small business which has risen faster than large business. I do not know that I would necessarily be concerned about that. One of the things you have got to recognise here is that the history is that banks have always charged fees to business—they did not charge fees to households. But businesses, whether it was large or small businesses, always were used to paying fees to banks. Households did not pay fees, and now they are paying fees, so obviously the increase in fees for households is much faster than fees for business.

It would not surprise me with businesses if small businesses paid smaller fees a long time ago than large businesses, so there is an element of catch-up there. Or the other possibility is large businesses have got huge turnover, so the fees per unit are smaller than they are for small businesses. But I do not know that I could read too much into that. It is only two years.

CHAIR—Yes. You say that you will have some more data available in a couple of months. Would the committee be able to receive that?

Mr Macfarlane—Yes, when we get some new data. These pieces of work usually take a long while to do. The first piece that we did for this committee on margins and profitability took about four years before we were satisfied that we had enough data and we could actually draw a conclusion. And the second piece of work we did on fees for households was just like this—we only had two years so we were really only able to come up with some preliminary findings. With this one, this is our first go at it. Now that we are collecting fees in this way—we are only collecting them annually—when we get some more we will certainly make them available to you.

CHAIR—Given the sensitivity of this issue I am sure that there will be a lot of interest.

Mr Macfarlane—I do not think the fee issue is as sensitive for business as it is for households because, as I said, households went from paying no fees to paying fees, whereas businesses were always paying fees.

Mr WILTON—The four major banks' total after-tax profit before abnormals was about $7.2 billion or 1.2 per cent of GDP with profits up about $900 million in one year. Has the RBA examined the profits of the four majors, and do these profits in your mind suggest that there is sufficient discipline on banks to compete through both lower charges and fees?

Mr Macfarlane—We have done a lot of work on this, not specifically for the four majors but for banks in general. I suppose the first thing to report is banks are profitable businesses, both in Australia and overseas, and we have looked into this. You will remember one of the pieces of work we did last time was whether they are maintaining their profits either by holding up their margins—the margin between the rate at which they borrow and the rate at which they lend—or by putting up fees. We concluded on the first point that that margin between which they borrow and which they lend has been whittled away, that their customers have gained, and the biggest area where the whittling away occurred was in mortgage lending, and that occurred because there was competition, although I will concede that the major source of that competition was someone who was outside the banking industry. But there was enough competition in the finance sector in Australia to whittle down those margins. Some of us thought that maybe bank profits would go down. They did not go down, really, by and large. Mind you, this is the phase of a cycle where banks' profits are at their maximum.

Was it because they were putting up fees to offset the reduction in margins? We did that study and we discovered that the increase in fees was very small compared to the reduction in margins. So how have they remained profitable? They have remained profitable because they have cut their costs. They have cut their costs for a whole lot of reasons—a lot of it is to do with technology, a lot of it is to do with reductions in staff, which is related to the technology, some of it is due to reductions in branches. We have looked at it, and we are finding the same sort of result here as people find in other countries, that banks have been able to remain very profitable by massive cuts in costs.

CHAIR—Just on this question of interest rates and household borrowings, one of the areas that has seen dramatic growth is the borrowings on credit cards. Do you have any information to show that that may be because consumers see this as a way of building up bonuses, frequent flyer points and so on?

Mr Macfarlane—I am not laughing at the question because it is the one that some of us have been pondering, particularly my colleague Dr Laker here who has responsibility for servicing the Payments System Board, and he is also a member of it. We think that is the case. We think that, certainly, there is a huge increase in transactions using credit cards as people seek to get their bonus points. I suppose if there is a huge increase in transactions some of it will stick, and so some of it will also be an increase in consumer card debt. I would not be at all surprised if that is part of the explanation.

CHAIR—So, in fact, those who are using these credit cards may indirectly be getting a benefit that other consumers are just not getting?

Mr Macfarlane—What you are saying is somewhere someone has got to pay for those bonus points.

CHAIR—Yes.

Mr Macfarlane—Somewhere in the community some prices are reflecting that so that that value can be transferred across to the people who earn the bonus points. Yes, that is true. In fact, we are sufficiently interested in this subject that we have started a study of it through the Payments System Board because there are other issues as well. Is paying by credit card the most efficient way of paying, or is it simply being done because people get their points? In some cases, there are more efficient and cheaper ways of paying for the economy as a whole.

CHAIR—I think you alluded to the use of credit cards in your annual report.

Mr Macfarlane—Yes.

CHAIR—Shall we move on to the Payments System Board because Dr Laker certainly had some views on the most efficient ways of people paying. We have talked about credit cards and billpay. Direct debit, which probably is the most efficient way, does not seem to have got either the right price signals or certainly consumer support, and I was wondering whether you might like to expand on why that has not occurred.

Dr Laker—That difference between our payments patterns and countries overseas became quite stark to the board when we started looking at how our country compared. It is the one area where we are in an anomalous situation. Other countries use direct debits quite frequently, and that usage has actually been going up over time. We are in the unusual position where usage is quite low and it has actually been falling over time. So in that area we are in stark contrast to other countries.

There are a number of elements in this which we need to understand more fully and that is why we are working on the subject. It is quite clear that loyalty points are encouraging people to use the credit card as a payments instrument and it is easy now for people to pay some utility bills on credit card. It is quite clear when you look at the way in which credit card usage has increased that it coincides with that period in which co-branded cards and loyalty schemes became available.

The other part of the story—the important part of the story—is that the Australian community, at this stage, has not learnt to love the direct debit. That is a cultural difference between us and other countries where the direct debit is very well established. Other countries have made an effort to make that instrument more attractive. They provide different kinds of consumer safeguards either in the form of guaranteed refunds or in trying to synchronise the direct debit to the payment of salaries. We have not tried those safeguards.

We are talking to billing organisations to see if it is possible to get a direct debit package together that will be more attractive to consumers because what is very clear is that it is by far and away the most efficient way of paying routine bills. That work is ongoing at the moment. We are trying to get what we would call a statement of best practice for billers to offer to their customers.

CHAIR—Are you saying that you are doing that through the Payments System Board or the Reserve Bank but other financial institutions are not really all that excited about it?

Dr Laker—The most immediate savings in bill payments go to the billers. It is becoming quite clear to them that some of the payments options are expensive on their bottom line so they have an incentive to try and make that process as cost effective as possible. That is why we have been working with them. It is for them to take this further, but the board has been happy to focus attention on it. The bank is happy to work with the major billing companies and then after that to talk to the financial institutions and consumers. It has to be a collaborative effort but the incentive in the first instance is to save costs and make our payment system more efficient.

CHAIR—I am curious as to why there has not been more interest there. If the banks are using a more expensive system, does that mean they may in fact be making just as good a profit out of the existing systems?

Dr Laker—I think at the end of the day the customer needs to be confident about how they pay their bills and confident they have some control over the timing of their payments for fear that they might be in dispute or subject to some sort of rogue bill that was clearly a computer mistake. For reasons that we are still learning, the Australian customer has not been as attracted to a direct debit, an automatic process, as other customers and that in part reflects the history of the scheme. In the UK where it is quite popular, the scheme has been in place for a long time, so it has been part of the way of life there. It is not part of our way of life.

Mr Macfarlane—One possible way of getting people to shift is if the billers gave them a discount for using a cheaper form of payment and direct debit is the cheapest form. Maybe the market might move in that direction at some stage.

Mrs HULL—Early in the year we had reports of a proposal to develop a reverse EFTPOS strategy. Does the banking industry keep the PSB informed of developments in this, such as the time frames and the management structures that might apply? Will we see any progress on reverse EFTPOS, particularly for my sections in the rural communities, in the near future?

Dr Laker—I am not sure what you mean by reverse EFTPOS.

Mrs HULL—Instead of taking money out at the supermarkets and in pharmacies et cetera, which often are the only places that we have to carry out banking transactions, are we going to be able to implement a scheme in which we can actually deposit money at EFTPOS facilities?

Dr Laker—Are we talking closely to the banking industry on that? No, not at this stage. I am aware of the background to this. There have been some initiatives, which we have seen wearing a prudential regulator hat, to try to use facilities in country areas—pharmacies, for example—to provide those sorts of banking facilities, and we see those coming to us as a banking development issue. It is not a matter that has come to the Payments System Board as such. We have really been looking, not so much at the retail end of making deposits and withdrawals at this stage, but more at the actual linkages in the payments system itself.

Mrs HULL—Would you think it is something that should come to the Payments System Board?

Mr Macfarlane—I am not sure it is a payments system matter. I understand and it is very interesting. It is pure banking. That is really deposit taking. I am sure that the physical mechanism is in place. If you get a refund you can get a credit to your account through an EFTPOS machine so the physical infrastructure in that sense is in place. It would seem to me it would be an issue of whether that particular merchant has got the facilities to store possibly large sums of money on their premises. The linkage is there. You can get a credit to your account through an EFTPOS machine at the moment.

Mrs HULL—Maybe we could have a further report on the likelihood that rural, regional and remote communities will be able to benefit from a reverse EFTPOS activity.

Mr Macfarlane—I will bring that up at the Payments System Board.

Ms GAMBARO—You were just mentioning direct billing and the need for a greater uptake of it because it is a most efficient way of conducting transactions. Do you think that there has been a large enough education program by the major banks to inform their consumers of the costs of their different products? There are hidden costs that people are not aware of. Do you think that more needs to be done in that area?

Mr Macfarlane—There is a lack of community understanding of these issues. In fact, we do not fully understand all the subsidies and cross-subsidies that are involved. That is why we are undertaking this study of what are called interchange fees. These are all the fees that pass between banks that issue credit cards and receive payment from the merchant every time a card is used. There is a complex web of transactions that go on underneath the surface and there is not a very wide knowledge of it in Australia. In fact, we confess that our knowledge of it is insufficient at the moment and that is why we are undertaking this study. The belief which a lot of people have that somehow or other these loyalty points or these frequent flyer things come from the generosity of someone or they come from nowhere is obviously not correct.

Obviously someone, somewhere along that chain of value, is paying a lot of money for something and the recipient is giving away some of it as a discount in the form of the loyalty points. That is the sort of thing that we are starting to look at even though there is not a huge community demand. The community is not saying they are horrified. The only sign of community unrest is that a number of merchants feel that they have to pay merchant fees that are too high for access to credit cards, EFTPOS or whatever it is. There is a little bit of community feeling there. Consumers as a whole I do not think have indicated any great worries. We think that we would like to know more about it.

Ms GAMBARO—Do you think that there is more that comes into play here like relationship marketing and intangible things that you cannot always measure accounting for the high increase of consumers using the cards? Talking about someone having to pay, the administration of such complicated frequent flyer programs is clearly a cost, wouldn’t you say?

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

Ms GAMBARO—I am trying to understand—coming from a consumer behaviour background—the behaviour that drives people to put their purchases on a credit card. I will put a scenario to you. A lady recently came to me and spoke about the fact that she was shopping around for a washing machine. The washing machine was cheaper in one retail outlet by some $80, yet she went to another retail outlet and paid full price because she wanted frequent flyer points. In your opinion, does that happen frequently? There is no logic in that; I cannot understand it.

Mr Macfarlane—I cannot believe it. I have not looked into it, but I cannot imagine there being enough frequent flyer points to make up a difference of $80 on a washing machine. But I think you are right. I think that many of these loyalty programs are designed to get people to change their behaviour, do things that they probably would not otherwise do if they were not there and, in extreme cases, change their behaviour, as this person did, in such a way as to actually harm themselves.

Dr Laker—I would like to add to that. The consumer has a positive incentive to use the credit card as much as possible because, if they are building loyalty points, it is actually not costing them at all. There is a small gain to them. We say it is a negative cost. That is a very rational response by the consumer to the pricing signals that are available at the moment. So an individual consumer has every incentive to use the credit card. What we are trying to understand is who, in the end, is paying for the higher cost of that instrument and the associated loyalty rewards.

Ms GAMBARO—To discourage people paying by cheque—and the true cost of a cheque has been estimated to be about $3—and to get people to use the direct billing technique, as a disincentive one of the health insurance companies will not give a discount. Do you know of many firms that are doing that? Would that be an adequate response to trying to get people to use direct billing more effectively?

Mr Macfarlane—Are you saying that this health insurance firm says, 'We'll give you a discount unless you use a cheque, in which case we'll charge you the full price'?

Ms GAMBARO—'If you use a cheque, we won't give you a discount, but if you use direct billing, we'll give you a discount.' You might have a case where older members of the community, or pensioners, et cetera, always pay by cheque or pay over the counter. It is a disincentive and they feel penalised.

Mr Macfarlane—I think these incentives, or disincentives, are a good thing, overall. I think that is the way we as a community will gradually move towards using much more efficient payment mechanisms and much safer ones than the cheque—the cheque is not a very safe one. Direct crediting and direct debiting are much safer. They have much greater security features than the cheque.

CHAIR—As long as the bill is correctly rendered in the first place.

Mr WILTON—On disincentives, in very general terms is the RBA aware of any moves by banks to potentially dissuade groups of depositors from banking with them? Would you consider investigating whether banks have any formal or informal policies in relation to that and whether the effect—direct or indirect—of branch closures and fee charges may be initiating such a shift?

Mr Macfarlane—Obviously, if you move from a system of zero fees to a system where you have a transaction fee, you are giving a disincentive to certain types of behaviour, and you are trying to get people to change their behaviour or, in some cases, change their behaviour to the extent of going somewhere else and taking their business elsewhere. That is true of any business; it is not just a banking issue.

If we get beyond that, if we move on to the things like branch closures, that is not really our responsibility. I think you are really moving into the area of consumer protection. Consumer protection has clearly been placed with ASIC. In fact, we ourselves are stretching our mandate a little bit by moving into some of these fee papers which we have done for this committee. I do not mind doing it because we started this work by working on margins and margins are central to our monetary policy mandate because a change in the size of margins affects the monetary transmission process, and it was only a small step from margins to fees. But as we move ahead, we have got to be aware that the Reserve Bank really could not initiate something which was purely a consumer protection issue. It should be done by ASIC.

Mr WILTON—So you do not wish to make any comment that banks may potentially, for example, be dissuading small deposit customers, especially those in rural and other smaller branches, from banking with a particular bank?

Mr Macfarlane—As I said, to the extent that they put on fees which are more onerous than alternative institutions like a credit union, people will change their behaviour. Obviously, if they close a branch, people are going to change their behaviour. These things are happening; they have been happening for a long time. All I am saying is that if it is being done in a way which is considered to be very unfair or discriminates against particular classes of people, that is a consumer protection issue.

CHAIR—As I recall, at the last hearing, you were a bit more forthcoming about the level of profitability of some of these branches that have been closed. I presume you still hold those views?

Mr Macfarlane—I am not sure that I said that. I said I have always thought—

CHAIR—You said that the profitability level was being set too high?

Mr Macfarlane—With respect to business hurdle rates, when people say that they have got to earn a 15 or 18 per cent rate of return on equity after tax, if everyone literally did that and never did any investment that was below that, we would not get much investment done. In fact, I think what happens is that they all profess to aim for that; fortunately, a large number of people still invest in things that do not reach that rate of return.

Mrs HULL—Mr Macfarlane, there is an entrenched community expectation of free banking services. I receive an enormous number of inquiries on apparently free banking services, particularly from the pensioner sector, et cetera. The question I would like to ask is: can and will the PSB publicise the real costs and the cost recovery process of the retail payment system? Would that assist us in ensuring that those on the lower socioeconomic scale might realise that they may be better off with a clean cost based fee for banking transactions? It is an issue that I think is particularly large in the lower income areas.

Mr Macfarlane—Yes, I would like to see very good data on the costs of various transactions. The cost of a cheque, as has already been referred to in these proceedings, is probably $3 plus. I am not sure where that number came from. I agree with it; it is the one I have always heard quoted and it sounds very plausible to me. We can give you the prices of particular transactions, but it would be very interesting if we could find the costs on which those prices were based. I think as the Payments System Board goes on, we will get more and more data on that. Dr Laker is looking at a table in the Payments System Board report. The problem with that table is that it shows ranges of estimates of costs, and the ranges are actually quite large.

Dr Laker—They are actually the retail fees.

Mr Macfarlane—It is the fees; there is also something with respect to costs. Obviously, it does cost something to provide all these services.

Mrs HULL—Just to follow up my question: do you think it would be possible that they will be publicised at a later date in order to get people to understand clearly the future of banking payments and services?

Mr Macfarlane—If we had them, we would be only too happy to release them. My memory of it is that the data, even from other countries, are not all that good.

Dr Laker—There was a study done a couple of years ago by what was then the Prices Surveillance Authority on retail transaction account fees. It found the same difficulty in getting robust data that would enable you to do the sorts of comparisons you wanted because costing systems were quite different in different institutions and their level of detail was quite different as well. It was quite a comprehensive study but it came up against this problem of getting the data in a form, on costs at least, that could be used to make your point.

Mrs HULL—It appears to me that, if somebody does not take it in hand and decide to seriously address this issue, then the current push for efficiency reforms would not be as successful as they could be.

Mr Macfarlane—What you are saying is that if the banks themselves do not have accurate measures of the cost of providing particular services how can they know whether they are doing the right thing in allocating the resources effectively.

Mrs HULL—Exactly.

CHAIR—We might move on to some other issues. I think Mr Pyne has a question he has been waiting to ask.

Mr PYNE—Mine is in respect of some international issues. In your semi-annual statement you had quite a commentary on Japan and some of the other South-East Asian nations and you said that there was obviously a recovery going on in Japan. Would you say that the recovery has established itself and will be sustained into the future, given how important it is to Australia?

Mr Macfarlane—I could make some comments on this but I think Mr Stevens would probably be able to make better ones.

Mr Stevens—Is there recovery in Japan? The facts are that we have had two quarters of rising GDP. There is now some talk amongst analysts that there may have been a rise in the September quarter—we do not know that yet but will find out in due course. It is clear that activity in the Japanese economy has reached bottom and increased. It is also encouraging that, as we read the data, private spending in Japan has actually grown this year.

One of the reservations about the sustainability of recovery has been that, in its initial phases anyway, it has been quite dependent on very large-scale government spending expansion and there is obviously a question as to what happens when those effects die away. On that, the Japanese government has announced a further package which will basically hold in that level of support in the economy through into the next year and, as I say, the evidence so far this year seems to be that private spending has begun to grow.

We also see some improvement in business and household confidence. They are still quite weak and there is a long way to go there but there are a number of quite encouraging signs, so I am cautiously optimistic that Japan will record growth this year. All the forecasters are now putting in positive numbers for 1999—quite a change from six months ago. I think that, if they can get that growth this year, it is likely that Japan will continue to grow gradually through into next year. As you say, if that turns out that is very advantageous for us.

It is probably also worth noting that Japan itself is actually starting to benefit a little from the recoveries in other economies in the region because their export performance is starting to improve. Some of those recoveries have been very strong—Korea in particular has had an unexpectedly strong pick-up so far this year. So one would not say that Japan is completely out of the woods yet but there have been a number of encouraging signs this year.

Mr PYNE—Would you expect that will lead to pressure to increase commodity prices, which would also be obviously beneficial for Australia?

Mr Stevens—Stronger global growth has already pushed up some commodity prices, particularly some of the metals and, of course, oil, which has risen quite steeply. So far, there has not been much action in some of the commodities that are important to us, particularly the bulk ones like coal, iron ore and so on. Some negotiations are about to get under way on those. I am not sure how that will turn out. A stronger Japan, a stronger global steel production, are certainly helpful for prospects on commodity prices.

Mr PYNE—In the semi-annual statement you also made comments about Indonesia, Thailand and Hong Kong, saying that while there were recoveries going on there, and they appeared to be very strong, there were still some continuing problems in respect of those three economies. Would you like to expand on that for the committee?

Mr Stevens—The recovery, such as it is, in Indonesia is clearly much weaker than in any of these other countries, as the chart on page 5 shows. That is not surprising, given the depth of the problems they have had and the compounding effects of political uncertainty and so on over the past year. Both in that case and in the case of Thailand to a lesser extent, the financial problems are serious. I believe the estimates of what they will cost range from

20 to 50 per cent of GDP to restructure banking systems in these countries. Those things cannot be done overnight. So they are a factor which I think makes it hard to get a strong recovery in the short term. I am not sure what else I can add on that.

CHAIR—It begs a follow-up question on the whole question of people talking about the Asian crisis being over. Given our involvement in the G22 and in the Financial Stability Forum, are you satisfied with the progress that has been made to put systems in place that will avoid seeing that crisis occur again?

Mr Macfarlane—I think some progress is being made. In fact, a lot of progress will be made, but whether it is enough, I do not know. The countries in question, the countries that got into difficulty, have set in motion a whole lot of changes. I do not think they will ever have banking sectors that are as sloppily supervised as they were. I think they will probably get quite big improvements in company law, bankruptcy procedures and accountancy standards that come out of this. So at the level of the countries that were affected, I think there are some very big changes being made.

At the level of the countries that were the ones that put the capital in and then took it out, there are also some changes, but not huge changes. For example, on the issue which we have talked about, hedge funds, I think there will be some significant improvements made in the disclosure that hedge funds have to make. I think that will be one of the outcomes, which will be a good outcome.

There has also been a change in intellectual climate in that, with respect to the tendency for the IMF and the US to use whatever pressure they can to get countries to open up their financial markets or their international capital flows prematurely, I do not think we will see much of that for a while. I think they have backed off. So the situation will be better, both from the point of view of the countries that got into difficulty and, to some extent, although to a smaller extent, from the point of view of the capital exporting countries.

Mr WILTON—The outlook for our exports is generally brighter because of a more buoyant world economy. Are you concerned that the markets might take something of a more bullish view and mark up the Australian dollar too quickly, in advance of rising commodity prices? Is there a prospect that if that happened, if the Australian dollar rose too quickly, it could put something of a brake on Australian export growth?

Mr Macfarlane—I am not very concerned about that because when I look back at what has happened in 1999 there was a period in about April where that looked as though that might be going to happen, but it clearly has not happened. The Australian dollar is not showing a tendency to move up. It is possible that at this stage of the cycle it might happen but it has not happened on this occasion. That is one of the reasons why I said, in answer to the chairman’s question, that the exchange rate has not been the significant input into decisions on monetary policy this year.

Mr WILTON—Given the strength of the US economy and improvements across Europe, do you see any reason why Australia should be focusing our export outlook on those parts of the world rather than on Asia in the foreseeable future?

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

Mr LATHAM—Mr Stevens, from your earlier comments can we conclude that you do not necessarily think the Asian economic crisis is over?

Mr Stevens—It depends on what you mean by the word 'crisis', I suppose. I think the period of contraction in economic activity, which was very steep and severe, finished probably some time during 1998—that is certainly what the data we plot in the report suggest. That is for the countries which were part of the initial phase of that crisis. Some other countries such as Singapore and Hong Kong slowed down later and have not turned up until more recently.

But, generally speaking, the period of contraction in economic activity and the maximum period of financial distress have clearly passed but there is the fall-out from those events in terms of an overhang of bad loans, the need to recapitalise banks and repair corporate balance sheets and things like that. There is progress being made there but they are still with us, as they were for some years in the case of developed countries earlier in the 1990s. So that kind of fall-out from the crisis is still with us but the period of contracting output and the period of maximum financial distress have passed.

Mr LATHAM—Part of the fall-out appears to be some sort of lagged impact on Australia's current account deficit. Mr Macfarlane, in your opening statement you pointed out that the current account deficit has reached six per cent of GDP in the June quarter and it is likely to remain at that level through the financial year. You go on to say, 'We think that the improvement could be some time in coming.' How long do you think it will take for Australia's current account deficit to go below six per cent of GDP?

Mr Macfarlane—I think it will get below six per cent probably as soon as we go beyond that period. The underlying logic behind that statement is that in the past, when our current account deficit has got above six per cent, it has often been because our economy has been growing extremely fast and then it has been followed by a sharp slowdown or a recession. When that happens the current account turns very quickly. But on this occasion we are not foreseeing that. We are foreseeing the current account improving, not because we are going to slow down sharply but because the rest of the world is picking up and I think that is happening more gradually. I really am just trying to say that there is a different profile this time. If we looked at it as a mountain, it would not be a sharp peak; it would be a sort of rounded one.

Mr LATHAM—I read from the semi-annual statement a concern—perhaps between the lines—of an emerging gap between consumption and output in Australia that could drive a domestic imbalance that pushes the current account deficit higher than where you would like it.

Mr Macfarlane—We are not pessimists on the current account. All we were trying to get at was that it was not going to be a pointy development; it is going to be a very rounded development. Everything that has happened so far in the current account would have to make you an optimist. To have such a huge disparity between our growth rate and that of our trading partners and to have falls in commodity prices, and for it still to take so long for the current account to get up to six per cent, has got to be a good sign for the future.

Mr PYNE—Does it concern you that the financial restructuring that is clearly going on in Asian countries is outstripping corporate restructuring? Would you like to make some comments with respect to that, either Mr Stevens or Mr Macfarlane?

Mr Macfarlane—It does not really concern me. I think you were alluding to the fact that there has had to have been big restructuring of banks. They have such bad loans that many of them simply could not continue to operate unless the government stepped in and took the bad loans off their books. The government fixed up each respective bank, turned it into a good bank, doing all the standard things that you do when you have a financial crisis. That is happening, although it is not happening as fast as we would like. An example of business restructuring would be the dismantling of the chaebol in Korea. That is obviously happening very slowly. It is happening slowly because it does not actually have to happen. If a bank cannot meet its commitments, it has to be restructured. It is just the nature of the difference between businesses which can be kept afloat and banks which, once they cannot meet their obligations, cannot be kept afloat.

CHAIR—Have we got any more questions on the international scene?

Mr LATHAM—Back on a domestic matter, back to the issue of the wealth effects: the first page of the semi-annual statement talks of wealth gains across a range of assets being part of the robust expansion in domestic demand. Mr Macfarlane, I understand that in the 1980s you were head of the research department at the bank that did a lot of work on the relationship between assets, booms, bust, prices and inflation. Was part of your conclusion at that time that it is prudent for government to tax capital and income at the same rate and not have distortions in investments patterns, property speculation and the like in the Australian economy?

Mr Macfarlane—I am not sure that I necessarily came to that conclusion. I certainly came to the conclusion that the interaction of a nominally based taxed system, which all tax systems are, and a reasonably high inflation environment and an environment of very high inflationary expectations were bound to lead to some form of asset price boom. The problem with asset price booms is that they break and when they break you get recessions. I was not an expert on the tax system and still am not an expert on the tax system. My feeling is that most of the sorts of distortions that we had in the 1980s have been eliminated by returning to a low inflation environment.

Mr LATHAM—Is it possible for them to reappear if there is a distortion in any part of the economy that gives higher economic returns to capital ahead of income trading, particularly in the context of pushing up the sort of wealth gains that are identified in the semi-annual statement for the first time?

Mr Macfarlane—That is possible. I am not sure whether it is likely but it is possible.

Mr LATHAM—Has the bank made any calculation about the wealth gains and the capital speculation that might arise from the recent Ralph business tax review and the halving of the capital gains tax rate? There was an estimate, for instance, by John Edwards, a market economist, for $28 billion unrealised gains coming back into the economy. Is that something that the bank has looked at?

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

Mr LATHAM—Is this something you plan to monitor in coming months? Might we hear more about it at the next semi-annual meeting?

Mr Macfarlane—We will always be monitoring asset prices.

CHAIR—Mr Macfarlane, it has been reported that Treasury is now dealing in derivatives as a means of trying to lower the cost of borrowing. Would you like to comment on that? Does Treasury really have the ability, skills and expertise to get involved in that area? Isn't there some risk? One would have to question whether that is the right sort of area that the Treasury should be dabbling in.

Mr Macfarlane—I think we have to be careful about what sorts of derivatives we are talking about. For example, we also deal in derivatives in our investment of our international reserves. If we hold a lot of assets in some particular currency and we like the assets but we do not like the currency, we will take an offsetting forward position in that currency to reduce our exposure to that currency. We also deal in futures markets which are derivatives.

It is really a function of how experienced you are, how good your control system is and, most importantly, how aware you are of the type of risk that you are taking. Some uses of derivatives involve a reduction in risk. Other uses of derivatives involve an increase in risk. I have no objection, in principle, to either a large asset holder or a large debtor using derivatives to change the nature of the risk that they are taking, as long as they know exactly how it has changed the nature of their risk.

CHAIR—That is really my question.

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

CHAIR—So you are confident that the skills are there?

Mr Macfarlane—I think Treasury at one stage felt that they did not have quite as many resources there as they should. They have taken steps to augment that.

Mr WILTON—Governor, the last 'Semi-Annual Statement on Monetary Policy' did place significant emphasis on inflationary expectations. Given advances such as the introduction of the GST and rising oil prices, are inflationary expectations a major concern to the bank next year? While the effect of those two events may well be temporary, if the expectations—albeit unfounded—do take hold, presumably you would have a bit of a job on your hands with both inflation and monetary policy.

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

Mr WILTON—Are the two main pressures in the bank's view underpinning your concerns about inflation outlook? First you talk about consumption and second you talk about stronger housing growth as it occurs in 1999-2000.

Mr Macfarlane—I did not hear that one.

Mr WILTON—I was seeking to get an idea of the bank's view of the two main pressures underpinning the inflation outlook. In your view, is it the housing growth as it has occurred in the 1999-2000 financial year, on the one hand, and just generally a stronger consumption, on the other hand?

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

Mrs HULL—Mr Macfarlane, following on from Mr Wilton's question, there is some opinion that using the monetary policy to restrict inflation should only be used to contain inflation arising out of demand and wage pressures, not to restrict unavoidable price increases and, more specifically, those price increases that result from a depreciation of the exchange rate. It is an opinion that you should not use monetary policy to repress those and that to do so may mean that Australians will not spend on locally produced goods and specifically not spend on imports then. Could you make comment on this opinion?

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

Mr LATHAM—Mr Macfarlane, what liaison has the Reserve Bank had with private sector forecasters about the estimated inflation impact of the GST? For instance, I noted a report by the Macquarie Bank that they thought there might be an initial GST impact of 3.5 per cent as opposed to the official Treasury forecast of 1.9 per cent. Do you liaise with these people, check out their material and reach conclusions thereupon?

Mr Macfarlane—We do not do it in any formal way but we are usually aware of what forecasters in the private banks are doing. We do when we do our survey of inflationary expectations. As well as having inflationary expectations of the public, we include the inflation forecasts of private sector economists there.

Mr LATHAM—Do you think the Macquarie Bank estimate of the first year impact of the GST at 3.5 per cent is closer to the mark than the Treasury?

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

Mr LATHAM—And how big is the risk that nobody can do it, given the distortionary impact of the GST and its impact upon conventional economic measurement? For instance, you have housing activity being dragged forward and car sales being delayed. Is there a risk that forecasts are just so—

Mr Macfarlane—Certainly the risks that you allude to there are real. Those two things are happening. But the main impact of that would be on the pattern of economic activity rather than on prices. Although it is possible that it is going to affect prices. Some people say that the price of getting work done on your house will actually go down after the GST is levied. At the moment, the prices are so high because the market is so tight: everyone is trying to get work done this year. Some people say that it will be cheaper to get it done next year. So it is possible that it could impact on prices, but the main effect will be on activity.

Mr LATHAM—And has the Reserve Bank got a estimate of where it thinks the September quarter CPI will be for next year?

Mr Macfarlane—No, we rely on the Treasury figure for the year.

Mr LATHAM—On another matter, and it is probably my final matter, I notice that the *Australian* newspaper reported on 22 October that you had told the Kellog Alumni Club that would be your last private chat show. Where do these chat shows fit into the transparency communication strategy of the Reserve Bank, particularly after the problems you encountered in exotically named Jackson Hole, Wyoming?

Mr Macfarlane—I did not speak at Jackson Hole, Wyoming; I chaired a session. At no stage did I speak publicly, nor did I speak to a journalist. So I have no idea how that report got back. On the issue of private meetings, I have tended to do these if I thought it was in the interests of the country. If there has been a group of funds managers from New York, or somewhere or other, and some investment bank has said, 'Would you address them?', sometimes I would. But it is now apparent that I cannot do those sorts of briefings, even though they have been done with the best intentions and all care has been taken not to say anything that might give indications of what is going to happen to monetary policy. It is now quite clear that I can no longer do that because, somehow or other, someone always manages to tell someone a second-hand, third-hand or fourth-hand report of what I have said, and it ends up in the newspapers. In respect of the meeting that you referred to in Melbourne, which I had committed to about nine months ago, I told that group that I would not do any more of these meetings. Needless to say, that ended up in the newspaper, that I was not going to do any more. Although, who knows? All sorts of things turn up—for instance, school speech nights, graduation ceremonies—which may or may not be regarded as private. But, certainly, I do not intend to do anything in future which could be regarded as private, meaning that it is not open to the public.

Mr LATHAM—So the communication strategy is based on what: explaining past events such as the extensive *Sydney Morning Herald* account of last year's currency crisis published on 25 September? Does the bank still see a legitimate role in explaining recent past events?

Mr Macfarlane—I am trying to remember what you are referring to. I think what you are referring to is basically almost a precis of what we had in our quarterly articles on the economy. There was nothing remotely confidential, nor was there inside knowledge in that article.

Mr LATHAM—No, there was no inside knowledge about the past; there is just history.

Mr Macfarlane—This hearing itself is a very important part. The fact that we have this twice a year, the fact that we produce this document for it, are very important parts of it. In addition to that, we also produce a document in the other quarters that are not covered by this one. I make public speeches and some of my colleagues, like those sitting on either side of me today, make public speeches and we have a list of articles and notes that we publish in our monthly bulletin. So I think we have extensive communication with the public and with the financial markets which add all those particular channels together. So I do not think it will be a great loss if I withdraw from anything that could be seen as being a private briefing.

CHAIR—Mr Latham's questions have prompted me to raise one question. There was an article in the *Financial Review* magazine a few days ago that spoke about the Reserve Bank. Its opening paragraph described what goes on in some of the board meetings. Are you worried that your board is now leaking?

Mr Macfarlane—No, I think the board has been very good. There were a couple of board members who were interviewed for that article. They both asked me whether they should agree to be interviewed, and I said yes. I think the board has been extremely disciplined and it has spoken with one voice which, fortunately, agreed with mine.

CHAIR—We are just wrapping up questions; I have got one that Dr Laker might want to answer. In the Payments System Board annual report, it was mentioned that 17 banks have met the three-day cheque clearing standard, while some others have not, including two notable banks. What progress has been made on that?

Dr Laker—Since that report was released, there is one other bank, Colonial State Bank, which has been added to that list. We will be back in touch with the banks that are not on that list through the course of the next year or so to see what progress they are making on reaching that standard. In our annual report we will draw attention to the choices that are available for Australian consumers between banks that offer that three-day cycle and those that, for whatever reason, do not. But we will work with the remaining banks to understand what it is that makes it difficult to get to that target.

CHAIR—Two of the majors still have not met it?

Dr Laker—They have not advised us that they have, no.

Mr WILTON—In a speech that the Deputy Prime Minister made in October this year to the Australian Council for Infrastructure Development, he said that he believed, in relation to what the government might do with future budget surpluses, that a strong case could be mounted for higher infrastructure development as our economy grows and that economic growth should be facilitated. Do you agree with that view?

Mr Macfarlane—It would not be a surplus in that case. You are saying that you spend it on infrastructure so you do not develop a big surplus. I have no objection to infrastructure development, and I think, if you were in this hypothetical case where you had this massive looming surplus, that would have a fair claim to be up there along with a number of other priorities as to what to do with it. My guess is that someone will find something else to do with it before that occurs. It would be nice to be in a situation where you could foresee a huge surplus and you were thinking, 'Well, what will we do with it. No-one knows what to do with it. I think I will do something with it.' But I do not think we normally get into that sort of situation.

CHAIR—As there are no more questions, I thank you very much, Mr Macfarlane, Dr Laker and Mr Stevens, for coming before the committee today. It has been a very valuable day and I hope that all those who have participated and attended have got value out of it, too.

Resolved (on motion by **Mrs Hull**, seconded 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 public hearing this day.

Committee adjourned at 1.14 p.m.