HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia's annual report 1995-96

SYDNEY

Thursday, 8 May 1997

OFFICIAL HANSARD REPORT

CANBERRA

HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

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

Matter referred to the Committee:

Reserve Bank of Australia’s annual report 1995-96

WITNESSES

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reserve Bank of Australia's annual report for 1995-96

SYDNEY

Thursday, 8 May 1997

Present

Mr Hawker (Chair)

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

The committee met at 9.45 a.m.

Mr Hawker took the chair.

CHAIR—I would like to welcome everyone here today. The committee is most encouraged to see so many people turning up and taking such a keen interest in the committee's hearings today and, in particular, the new Governor of the Reserve Bank.

I now declare open this public hearing of the House of Representatives Standing Committee on Financial Institutions and Public Administration. Today's hearing is unique in that this is the first time the recording of a parliamentary committee's hearing is not being done by Hansard. Welcome to our new parliamentary outsourced recorders.

The purpose of today's hearing is to provide an opportunity for the Reserve Bank to report on the conduct of monetary policy and the hearing is being conducted as part of the committee's review of the Reserve Bank's annual report. Before we start, I would like to make a few brief comments. As part of the framework of Reserve Bank accountability, outlined in the Treasurer's statement on the conduct of monetary policy, the Governor is to report to this committee on the conduct of monetary policy twice a year. This is the first appearance by the Governor as part of that process and the next appearance will be in November, I believe, just after the Melbourne Cup.

The committee welcomes this move to make the conduct of monetary policy in Australia more transparent. It not only assists the parliament to play a more positive role in the process, but it also assists in ensuring that the broader community becomes aware of the issues influencing monetary policy. The Governor and the Treasurer deserve credit for providing this opportunity, which builds upon a process initiated by this committee about four years ago. I am sure the members are keen to hear what the Governor has to say this morning, so I would like to get proceedings under way straightaway.

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

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

STEVENS, Mr Glenn, Assistant Governor—Economic, Reserve Bank, Martin Place, Sydney, New South Wales

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

Mr Macfarlane—Yes, thank you, Mr Chairman. I will continue the practice that we have adopted and make a statement. First of all, I would like to repeat some of the things that you said. It is a pleasure for me and my colleagues to be here this morning. It is, in fact, the sixth time that some of us have appeared before this committee, but it is the first time under the new arrangements agreed between the Treasurer and myself at the time of my appointment and contained in the document known as *The statement on the conduct of monetary policy*. That document was an important step in making the Reserve Bank's independence clear and we have always taken seriously the responsibilities that go with that independence.

One important responsibility is to explain carefully and honestly to the public and the parliament what we are doing with monetary policy and that is why we had no difficulty in agreeing to the proposals contained in *The statement on the conduct of monetary policy*, including the two which are relevant to today's meeting. The first was that the bank should report to this committee twice a year and the second was that the bank should release a statement on the conduct of monetary policy and the role it was playing in achieving the bank's objectives and I assumed that most people here have got a copy of that report.

We have decided, in fact, to coordinate those two twice-yearly requirements, so that the statement, which we have named the *Semi-annual statement on monetary policy*, is available immediately prior to this meeting and can form the basis for some of the discussion. The bank now makes an increasing amount of information available to the public. Years ago, our annual report was almost the only vehicle, but now it is supplemented by a substantial flow of information in the form of press releases, articles in our monthly bulletin and speeches by senior officers.

The additional benefit that the parliamentary hearings will bring is that these hearings are a two-way process. Monetary policy inevitably contains an element of judgment and judgments can differ between knowledgeable and well-informed people. This forum allows members an opportunity to express different views and to pose awkward questions; two activities I am sure you will engage in to the full. This is a useful addition to the other checks and balances which are part of the democratic process.

In this opening statement, I would like to say a few words about the economy, monetary policy and financial markets. I would like to begin by giving you a brief summary of our reading of the economy's current conjuncture and short-term prospects. As usual, the performance of the Australian economy is a mixture of some very good aspects and some that are in need of improvement. Over 1996, GDP grew by around three per cent with inflation at about two per cent in underlying terms. This, the fifth year of the current economic expansion, is a pretty good result by the standards of developed countries. Over that five-year period, only two other OECD countries out of the 25 have done better on growth and they were smaller countries: Norway and Ireland.

Having said that, however, we have to concede that 1996 represented slower growth than in the previous few years and meant that the earlier decline in unemployment halted. We believe that in the period ahead, we will see an improved rate of economic growth, which we see as something more like four per cent through 1997 than the three per cent we had over the previous year and we believe that four per cent should be quite sustainable. At this stage, there is no reason why good rates of growth should not be achievable for a number of years to come. Behind this view of a pick-up in growth are several factors. Consumer demand was very weak during the second half of 1996, but is now looking stronger. We had a very strong figure for March and, even allowing for the normal quarter to quarter variation, we think this is a pointer to better overall growth during 1997.

We should not, of course, be looking for a boom in consumer demand. The need for improved savings remains great and a moderate growth in consumption would suffice. To that, I think we can add that the upswing in the residential construction cycle has now started after two years, during which that was very weak. The signs of the upswing come from a clear pick-up in lending, a pick-up in local government approvals to build and in the December quarter, and we believe in the March quarter, a pick-up in housing starts. Business investment should continue to be solid. The picture varies across industries, but overall investment spending is likely to grow further, driven by a quite strong increase in construction and moderate growth in plant and equipment. Unlike the late 1980s, the construction upswing is broadly based, including in mining and infrastructure spending, rather than being concentrated in office blocks and hotels.

The overall financial climate should also underpin investment plans with share markets throughout the world, including Australia, at record highs and with bond yields and bank lending interest rates at or near their lowest levels in this cycle. The international environment is generally supportive of the Australian economy, though as always there are things to watch. Growth is proceeding and probably picking up now in Japan and Europe, which have been weak for several years. In the United States, the federal reserve has the job of slowing the economy back to sustainable rates of expansion without overdoing it. We all have a big interest in them succeeding. In East Asia, growth is generally expected to pick up after a small lull. It is important that it does so, because the region has been the major destination for Australian exports in recent years.

This outlook is a generally favourable outlook for the world economy. It is moderated slightly by the fact that some countries in the forefront of this expansion, such as the United States and the United Kingdom, have reached the stage in their cycle where monetary policy is now being tightened. In the United States, monetary policy was tightened in March; in the UK it was tightened earlier than that and again, yesterday, it was almost the first thing that the incoming Labour government did.

Overall, we see reasonable prospects of growth ahead and we think it will be better than last year.

This should do something to help a lacklustre labour market. The labour force figures have been particularly hard to get a clear signal from in the past couple of months. Around the turn of the year, it appeared we were getting good acceleration in employment growth; the past couple of months, however, have seen that unwound. We will get another reading today. Whatever that may show, it is unwise to get too carried away by short-term trends. What can be said with reasonable confidence is that employment growth has been weak over the past year, but that leading indicators, particularly vacancies, are signalling some strength in future. We cannot be sure how robust that will be, but some pick-up in employment would be consistent with the growth picture that we anticipate. This is the thrust of the analysis in our statement.

Inflation meanwhile has come down. Underlying inflation peaked at 3.3 per cent a little more than a year ago, but has now come down to a level of about two per cent—2.1 per cent in the latest figures. It was this decline which made room for the three easings of monetary policy, which we put in place in the second half of last year. The decline owed something to the slower economy, which increased competitive pressure in many markets, constraining firms' ability to raise prices. The same factor helped for a while to produce some slowing in the growth of labour costs. A third factor in the slowing in inflation was that the Australian dollar firmed during 1996 and this has pushed down prices for traded goods and services.

In the next year or so we expect to see a continuation of low inflation. Beyond that horizon, as the recent exchange rate effects wear off, the ongoing rate of inflation in the domestic price and cost structure will re-assert itself. At present the domestic part of inflation appears to be higher than the overall underlying inflation rate; for example, private sector service prices are growing at 2½ per cent and domestically produced goods are growing at 3.3 per cent. Containing growth in labour costs is important to sustaining a combination of good inflation outcomes in the domestic economy and good growth in output and employment. I will return to this theme shortly.

I would like now to turn to some aspects of the operation of the monetary policy regime itself. A central part of our framework is the inflation target which in essence says that inflation should average two point something per cent in the long run. We think this target has helped to bring the community's inflation expectations down but there is still further to go. Lower inflationary expectations are important in achieving a good combination of low actual inflation and sustainable expansion in the real economy. Low inflation and our inflation targeting arrangement also have helped to build credibility internationally for Australia's policy generally. This is not just a matter of pandering to markets. It is worth having for genuine reasons. One of those reasons is that long-term interest rates for all borrowers—government, business and household alike—are lower if we can convince lenders that we are likely to keep inflation down.

Because we have an inflation target, some people think that means we do not pay attention to economic growth or employment. This is not true. To paraphrase my predecessor, we do because our charter requires us to, but more importantly because it is sensible to do so. In thinking about how best to live up to this objective, however, a central bank has to have a longer time perspective than some other observers may adopt. It is long, durable expansions in the economy which offer the best prospects for building a solid base of industry jobs and prosperity. Our observation of history, moreover, is that good growth and long expansions have always gone hand in hand with low inflation. Weak growth and short expansions have been a feature of the high inflation era, particularly in the 1970s and for parts of the 1980s.

We want and need a long expansion at this time. We do not want the expansion to last only six and a bit years and be followed by a serious recession, as on the last two occasions. The damage to unemployment occurs during these recessions. The net rise in unemployment in Australia over the past 25 years has not been due to periods of prolonged weak growth. It has been concentrated into three relatively short periods of recession. The best thing that we can do to improve our employment prospects is to prolong the expansion, improving its durability by avoiding inflationary and other imbalances, thereby delaying and reducing the severity of any future recession.

Making this a long, sustainable expansion is our main objective. Continuation of low inflation is a means towards that end. While seeking to maintain that long-term perspective, we are continually monitoring the information that comes in on the economy to see whether it is sending us a message about the need to change policy. When we saw evidence of lower inflationary pressures in the middle of last year, as I said, we took the opportunity to lower interest rates on three occasions: July, October and December. I found myself in the position of initiating monetary policy easings at two of the first three monthly board meetings I chaired.

Now, I expect that there will be a view that with inflation at the bottom of the two to three per cent range and with the possibility that it could go a little lower for a while, and with the economy having grown more slowly during 1996 than its potential, many people will be asking, ‘Why not keep easing?’ Part of the answer is that the full effects of the previous three easings have not yet come through. We need to keep this in mind. One possible hurdle to lower interest rates was removed in the Australian Industrial Relations Commission’s decision in the safety net review or living wage case which sought to carefully balance concerns about the living standards of the low paid and the economic sustainability of widespread and substantial rises in income for these people.

The decision was moderate and it increased the probability that aggregate wages growth would be consistent with continued low inflation. Other information received recently has been less reassuring. The various sources of data on wages paint a picture which is far from straightforward to interpret, but one series on which we place a good deal of weight, though not exclusive weight—average ordinary time earnings for adults working full time—has shown and seems to be at levels which at the moment are too high. From the quarterly run of figures, when you look at them, it is hard to conclude that the earlier slowing in average wages has continued. If anything, the picture that the figures paint is one of continuing acceleration over the last five or six quarters.

More information about aggregate wages will be available soon, as will data on enterprise bargains. In the meantime, the continuing substantial claims—and, in some cases, settlements—that are contained in some current negotiations, including but not confined to the metal industry, give us less than full confidence that the bargaining stream is moderating appreciably. Overall it is difficult to escape the conclusion that wage bargains and average wage outcomes are somewhat higher than they really should be in an economy characterised by low inflation and quite high unemployment. This conclusion also emerges from international comparisons. As the semi-annual statement documents, most developed countries now have inflation rates similar to ours, around two per cent, and they have rates of growth of earnings around three per cent or in some cases four per cent.

Australia stands out as an exception where low inflation has not translated as fully as it should have into lower wage growth. Whether aggregate wages growth of 4½ per cent and enterprise bargains of 5 per cent, or 5 per cent plus, are bound to lead to higher inflation is a moot point. In some sectors, such as manufacturing, they are probably not inflationary. The squeeze in manufacturing seems to be showing up as higher unemployment rather than higher inflation. Firms may well accept 5 per cent wage increases but manage to keep the increases in their total wage costs much smaller than that by shedding staff. In other sectors of the economy which are not so open to international competition, such as transport, higher wages will probably be passed straight on to consumers as higher prices.

I would like to be in Alan Greenspan's place, where over the past 15 months he has been regularly surprised by information that showed a stronger economy than they were forecasting but better news, month by month, on inflation and wages. Even though the economy was growing faster than forecast, inflation stayed virtually steady and even though wages rose, they rose only very moderately and they are much lower than they are in Australia, or wage growth is much lower than out here. In Australia, given the degree of slack in the economy, and the level of unemployment, I thought we might also have been surprised by some lower than expected wages numbers. Overall unfortunately we are not in that position and we are still waiting for some good news.

I will now turn, if I can, to financial markets. As we have noted in the statement, the exchange rate of the Australian dollar has moved to a flatter trend over the past year after rising strongly in the second half of 1995 and the first half of 1996. If anything, the exchange rate against the US dollar has been a little lower in 1997 than it was in the second half of 1996 and it has been reasonably steady against most of Australia's other trading partners. In trade-weighted terms, however, it has risen recently. At its present level of 60.4 it is about four per cent above its level a year ago. This rise has contributed to the fall in inflation, as has the earlier rise, and has put some pressure on the internationally traded sector of the economy. Overall, however, the exchange rate remains at about 5 per cent above its longer run average.

The trade-weighted index reflects a wide range of influences but the main reason for the rise in the index over the past year, or particularly over the past three or four months, has been the extraordinary weakness in the Japanese yen. The yen has fallen against all major currencies on world markets but its effect on the Australian trade-weighted index is greater than for other countries because the yen has such a big share in our trade-weighted index. There are some hopeful signs that Japan is emerging from the very difficult period that it has been through which, of course, in due course will allow the authorities there to return their monetary policy to a more normal setting. At the moment short-term interest rates in Japan are half a per cent. That would also provide some support for the yen which, all other things being equal, would probably reverse some of the recent upward pressure on Australia's trade-weighted exchange rate.

In terms of other financial market developments, we have seen marked falls in interest rates over the past year, not only at the short end but also on longer-term rates set in capital markets. The yield on 10-year bonds, for example, has fallen by over 100 basis points over the last year to about 7¾ per cent. This reflects the improvement in the Government's fiscal position and the fall in inflation, rather than international influences. So our yields have not only fallen in absolute terms, but also they have fallen relative to those overseas. For example, a year ago our bond yields were 250 basis points above those in the United States. Today they are only 100 points above the rates in the United States.

The fall in bond yields has also had important benefits for business and government, not only in directly reducing their interest costs but also by increasing confidence in the share market and thereby allowing businesses easier access to equity funds. Share prices in Australia are at record levels at present, reflecting the favourable interest rate environment and generally higher levels of corporate profitability. Share markets in most other industrial countries are also at extremely high levels, often at record levels. Interest rates on offer throughout the banking system have also come down sharply over the past year. This has been underpinned by the three easings in monetary policy but also, particularly in the case of housing loans, by a marked increase in competition and a reduction in margins.

Business loan rates have fallen by about 1½ per cent since mid-1996 in line with the reduction in cash rates brought about by the easings of monetary policy. In fact, those rates at present are close to the lows reached in 1993-94. In the case of housing loans, rates have fallen by three per cent over the year to about 7.5 per cent for a standard housing loan, which is the lowest level in a generation. If we also take into account the absence of rationing that we now have in a deregulated financial system, housing finance is probably more affordable and more accessible than at any previous time in Australia's history.

It is not surprising, therefore, that we are seeing a healthy demand for credit at present with all forms of credit, both to households for personal purposes and for housing and to the business sector, growing at about 10 per cent per annum. This and our more general assessment about financial conditions leads us to the view that financial conditions are not impeding the expansion of the economy at present. Thank you very much, Mr Chairman.

CHAIR—Thank you very much, Mr Macfarlane, and I trust that the committee's questions will not be seen as being too awkward but hopefully we will elicit some more information and be reasonably searching. When you talked at some length about inflation and you mentioned three factors that you could see that were of some significance in terms of a slower economy, some lower outcomes in wages growths in some areas, and also the effect of the appreciation of the dollar, and I was wondering which of those three you see as the most significant factor in reducing inflation.

Mr Macfarlane—It depends what time period we are looking over. If we are really looking over a long time period—for example, why have we had 2½ per cent inflation over the last five years compared to the eight per cent inflation we had in the 1980s or the 10 per cent inflation we had in the 1970s—then I think it is the domestic cost structure that has come down; domestic costs and wages have been the important factors. If we are looking over a much shorter period—for example, if we are asking the question of why inflation came down from that 3.3 per cent I quoted to the current 2.1 per cent—probably the biggest single factor in that recent reduction would be the appreciation of the exchange rate.

CHAIR—Thank you for that. I guess one area we are going to be looking at it in some detail is interest rates, and you have spoken about that at some length. I daresay it would have been quite pleasant in your board meetings to be able to come forward with what I think for most people was some good news. Given that you have suggested that the effects of those interest rates easings are only just starting to flow through, would it not be reasonable to assume that, if we are going to get full benefit, that would put the pressure on to try and keep those interest rates down for as long as you can?

Mr Macfarlane—It is always difficult to respond to questions that imply setting out a course of monetary policy into the future, but I certainly would agree with the sentiment that you express. I think that it would be extremely disappointing and surprising if a reversal of course had to occur in any immediate period. We should be expecting that that would not prove necessary. I certainly would hope that it would not prove necessary. But as always, in talking about monetary policy, it is very difficult to make any commitment because no one can predict exactly what is going to happen in the future. But on the basis of previous occasions, we have tended in Australia to make our movements in monetary policy I think quite early—the word there is 'pre-emptive'—to do two or three quickly and then have it followed by a period of stability. So I think if you looked at the experience of the last five or six years you would see that that is the sort of pattern that has emerged and we hope that that is the sort of pattern that could emerge on this occasion.

CHAIR—I think we will be pleased to hear you refer only to the last five or six years because prior to that it was somewhat different.

Mr Macfarlane—Yes.

CHAIR—Nonetheless, we could just try and extrapolate that a bit further. I think one of the other things is in your semi-annual statement, if you look at one of the graphs on the differential on page 28. You have there a graph showing the growing gap between small business, housing and large business, and you make reference to it in your statement. The fact is that while business lending has probably dropped by 1½ per cent, housing has dropped by 3 per cent. Do you feel that it is a healthy trend to be seeing that gap growing, given that we are talking about trying to deal with things like unemployment and a few other matters?

Mr Macfarlane—I think if you were a housing borrower you would say it was healthy. I think it is worth going through some of the history of bank lending in Australia because I think things happen in stages. We had a very sheltered, protected, regulated banking sector for many, many years. We deregulated in about 1983-85 and allowed foreign competition to come in because we thought customers were not getting a good deal from the old heavily regulated banking sector. The competition worked immediately in one sector. It meant that there was intensified competition for lending to business—particularly big business—because the competitors who came in were big international banks that did not have any grassroots network in Australia, but they knew a lot about lending to big businesses where there was a lot of information and you can read all the accounts and know what you were doing.

So we saw intense competition to lend to big business. In fact, we all know that there was too much competition and some rather foolish loans were made and at the end of that particular phase there were some fingers burnt. When we moved to the 1990s, what we saw was banks rediscovered mortgage lending. You do not have to lend to the big end of town, you can lend to the household sector and you can do very nicely out of that. So we saw a huge increase in lending to mortgage borrowers.

Now, for a time it was extremely profitable for banks because the margin on lending for housing was very high by international standards—in the order of 400 basis points—and when I used to come to this committee people used to ask the question, 'Why is this margin so wide? How can banks get away with it?' We kept saying, 'Well, competition will come and it will all be narrowed,' and I have to say we were very disappointed in how long it took for that competition to come. But eventually the competition came in the mortgage market, and not just the mortgage market but all the other personal lending market which keys off a mortgage. The competition, of course, came from outside the banking industry; it came from the mortgage originators. So we saw this huge margin shrink to probably 150 basis points as it is now, which is about as narrow as you would expect it to be. It is almost average world standard.

That in itself is a very good thing, and we do not want to put mortgage rates back up again in order to keep some constant ratio to small business loans. Now I think we are reaching the third phase where I think that competition is going to start—and, in fact, it has already started—spilling over into small business loans. Small business is the hardest form of lending to do because the information there is very difficult to obtain, particularly if the business is new. It is a very tough form of lending and it is probably inevitable that it would be the last area of lending to be affected by competition.

But if we go back, we can already see some gains. If we go back to 1994 when the monetary policy tightenings pushed up the short-term interest rate structure by 2¾ per cent, we have forgotten probably now, but at that period what the banks did was that they did not put all the indicator rates for business or for housing up by the full 2¾ per cent—they put them up by 1¾ per cent. How did they do that? They did it because they did not put the deposit rates up very much either. So on both sides of their balance sheet the interest rates went up by less than the cost of funds. Already, at that point, that was an advantage whatever borrower you were: small business, big business or household.

Now that interest rates have come down by 1½ basis points, those indicator rates have come down by the full 1½ basis points. So what that really means is that, even though our cash rate now is 1¼ per cent higher than it was at the absolute low point in late 1973, the indicator rate for small or large business borrowers is now only a quarter of a per cent higher than it was then, so the borrower has actually gained over that period by not having their interest rates follow exactly along with the cash rate. The rate that the business borrower gets now is clearly lower than would have been indicated by the movement in the cash rate. This is getting to be rather a big question with rather big answers, so I am happy to elaborate further. I am sure there will be people who have other questions to ask on it. But I think the crucial thing is that we are starting to see the early stages of the sort of competitive pressures in small business lending that we saw in housing lending three or four years ago.

CHAIR—Thank you, Mr Macfarlane. I guess that does beg another question. If competition issues are the way you see of forcing that rate down for smaller businesses, the follow-up question would be whether you therefore see the best way of getting that competition by creating a greater diversity in credit providers—whether it be banks or others or more foreign banks or foreign credit providers coming into the market—as a means of getting that pressure on business, particularly the small business end of interest rates?

Mr Macfarlane—That is a good question because I think this is where some people were disappointed about the previous phase of foreign bank entry. The foreign banks came in, they provided competition but they seemed to only provide competition at the big end of town and not at the small end of town. So what is it going to do for the small business borrower? Where is the competition going to come from? I think it is coming from a number of quarters, but ultimately it probably will come from competition between the major banks themselves, including the regional banks.

Because of the squeeze in the margins on mortgage lending, that is no longer as profitable for the regional banks—that is the state based banks—as it used to be, so they are realising they cannot run a viable long-term business on just mortgage lending. So those regional banks are moving more and more into the small business end of the market. That is the first area where it is hotting up. So that is an example of where the competition on housing then spilled over into this other area.

There are other sources of competition as well. There are some banks that are going after the well-heeled small business borrower and are prepared, where they judge that the risk of failure is very low, to offer very attractive terms to lend to them—usually always, of course, secured lending. But there are some smaller banks that have not got a big branch network but who have been targeting what they regard as particularly attractive small business borrowers and offering them terms which are almost the same as the terms they are offering to large business borrowers.

Now the big banks are, in fact, also introducing a lot of new products which seem to be quite reminiscent of what they did in the mortgage market. They are introducing products with lower interest rates so the indicator rate is, say, two percentage points below the normal indicator rate. There will still be risk margins on top of that, but probably the all-up cost will be a couple of percentage points below what the main interest is being paid by small business borrowers. They are introducing them to new customers. This is very similar to what the banks did in the mortgage market when they introduced the so-called ‘honeymoon loans’.

So the marketing people there have obviously decided that they want to do the same thing. They do not want to go around and offer lower interest rates to all their established customers but they want to be on the lookout to gain new customers by offering what used to called ‘honeymoon deals’ in the mortgage area. This is producing quite a lot of competition now. At the moment they probably have not allocated really large sums of money to do this but the competition is going on at the margin. I would imagine that, as small business customers become more and more aware of this, some of the customers who have got an existing loan and are paying the two percentage points higher than maybe they really need to, if they are confident that they are a good banking proposition, will be able to shop their business around. This is exactly what happened in the mortgage lending area where banks attempted to offer a lower rate to the new customer than what the established customer was paying.

My feeling is that the market for lending to small business at the moment is looking not that dissimilar to what the mortgage market looked like three or four years ago. I think there is only one direction it can go and that is for the competition to heat up even further, but there still will be small businesses that are going to find it difficult to get funds, particularly new businesses. It is always going to be difficult if you have not got a track record. If you have got a small business that really depends on the owner/manager and a small amount of capital equipment it is always going to be a difficult lending proposition. I think what is happening is that the better risks in the very small business area are gradually going to be able to find more products available to them and banks will be competing with each other more than they did in the past.

CHAIR—Thanks. I will just follow up briefly on that and then I will ask other members of the committee if they have anything to ask. We will talk about monetary policy in a moment but I would just like to clarify that point again. You are saying that not only competition but also a greater and more diverse range of lenders is the way to keep that pressure on.

Mr Macfarlane—I think we are seeing a greater range of lenders. We are also seeing the regional banks becoming much more serious about small business lending, rather than just relying on the easy money they were getting out of mortgage lending. Secondly, some of these are foreign banks which have not got a branch network, and one would normally think of them as only engaging in large scale commercial lending, are going in and trying to pick off the best small business customers; some quite small business customers. That is heating it up.

I have not mentioned this one on the way through, but thirdly, there are some attempts being made to provide loans to small business customers secured by mortgages and then having the mortgages securitised and sold in the market place. I am not sure just how far that will go but people are trying to do that, trying to do what they did with the mortgage market and trying to move that into the small business market. It is not as easy as it sounds but it is there at the margin. The final one is, basically, that the large banks have responded. They see the writing on the wall. It is going to get more competitive and so they have started to introduce new products at substantially lower interest rates but these new products at the moment are only available to new customers and, obviously, to new customers that can establish that they are pretty low-risk customers.

Mr ANTHONY—Mr Macfarlane, just following on from those comments regarding the housing market, you point out in your semi-annual statement that there is a resurgence now in residential property that seems to be driven by lower mortgage rates. I note that it says in the report, on page 10, that credit to the household sector over the year to February grew by 11 per cent. You also state on page 12 that financial deregulation is giving many householders greater access to credit as well as expanding the range of financial services, which you elaborated on a few moments ago. Is there some risk that, with the expansion now of credit available due to low interest rates for the housing sector, this is having a fairly major impact on a reduction in overall consumption spending, because you also note that there has been a decrease in disposable income? Are we getting one sector of the economy being a major beneficiary, because of lower rates, to the detriment, let us say, of overall consumption in other parts of the economy?

Mr Macfarlane—That is a difficult one to answer. I think we believe that people should have access to finance on reasonable terms and financial deregulation has certainly done that. The question is whether they will take on too much debt. I do not think it is a problem for consumption because a lot of that debt they are taking on is either to buy a house or in some cases they are using the security of the house to buy other consumption items such as a car or a boat or something like that. So it is not going to harm consumption and it is not going to harm the suppliers of other goods and services in the economy. The issue is really whether it is going to reduce the amount of savings and I have to say I think it does.

I think that a really free financial system would probably mean lower savings because I think some of the savings that occurred in the past occurred because people simply could not borrow money to buy the things they wanted to buy so they saved up and then when they got the money they bought it. So I think there is an element of that, that a very free financial market does not contribute to high savings.

The second issue is: will people actually get into trouble, will they borrow too much? I know some people are worrying about that and at the moment we do not see that as a problem, although we know it is a potential problem. We saw the business sector in Australia borrow too much in the 1980s and during that period the household sector was quite restrained and very conservative.

We look around the world and we ask whether we are getting out of line, and I think the answer seems to be that we are not. On page 11, I think, of the Semi-Annual Statement there is a comparison of how much borrowing households have done around the world and we are actually in the middle of the field. Our households have not geared up as much as they have in the United States, the United Kingdom or Canada but they have more so than the European countries, so at the moment we think we are sort of in the middle of the field.

The test case—the example that people who are worried about households over-committing look at—is the United Kingdom, where in the 1980s boom in house prices it was quite clear that the household sector went overboard. They borrowed too much, and the more they borrowed the more they drove up house prices. The more house prices went up, the more people were desperate to borrow some money to get in and then when house prices fell—and they fell by a big amount in the UK—we found people who were in far too deeply and there was quite a lot of personal distress and a lot of people lost their houses. The concept called negative equity arose, which means that you owe the bank $200,000 and the house is only worth $160,000. We have seen an example of where that has gone too far and we do not think it is happening here. The first sign of it happening would be if there was an asset price boom in housing prices. Some of that is happening around inner Sydney and inner Melbourne but it is not a general phenomenon at the moment.

CHAIR—I just make the observation that in the last 16 years, according to page 11 of the report, the household gross liabilities have gone up nearly 50 per cent, so it is not insignificant.

Mrs GALLUS—Mr Macfarlane, I was interested in your answer to the Chair's first question. You said that the biggest single factor in bringing inflation down from 3.3 per cent to 2.1 per cent was the appreciation in the exchange rate. As you later pointed out, some of that was due in the trade-weighted index to the Japanese yen and the depreciation of the Japanese yen. As the Japanese economy stops its volatility we will expect to see that change and an appreciation of the Japanese yen. Do you see that being accompanied by a depreciation of the Australian dollar and, if you do, do you see that putting pressure on inflation and therefore putting pressure on the need to tighten monetary policy?

Mr Macfarlane—Your account of the mechanism I think is right. I think one would have to assume that the yen is at an extraordinarily low level at the moment. It is not that long ago—the first half of 1995—when the United States dollar would only buy 80 yen and now it can buy nearly 130. This is an extraordinary change in the exchange rate for the two biggest currencies in the world over a period of less than two years so I think, in doing medium-term planning, most people would assume that the yen at some stage is probably going to be a little stronger than it is now. That does not worry us. We thought we would factor that into our thinking and we are not worried because the trade-weighted index in Australia has risen so much since early 1995 that some change there, or a reduction there, would not be of great concern to us.

Mrs GALLUS—You do not see the dollar depreciating as a result of that?

Mr Macfarlane—Having watched the trade-weighted index go up largely because of something that had happened to the yen and not said, ‘Well we have got to do something about it,’ I do not think that if we see it in reverse we would say, ‘We would have to do something about it.’ Because we would see that as being something that is really related to what is happening in Japan, rather than what is happening here.

Mrs GALLUS—If I can follow it through with that, we saw an appreciation in the dollar and it has levelled off now. If the dollar does depreciate for whatever reason, if it continues to stabilise and then go back a bit, do you see that then as putting any pressure on the inflation rate?

Mr Macfarlane—Changes in the exchange rate do affect the inflation rate. The way we conduct our monetary policy here is that we are more tolerant of variations in the exchange rate than other countries that have an inflation targeting regime. We accept that the Australian dollar goes up and down around a flat trend. It has been flat—if we draw a line through it since the big fall in the early 1980s, the trend has been flat. It has gone up and down by quite big margins around that and we have been prepared to tolerate quite big substantial movements in the Australian dollar. We know that they will have some effect on inflation, but if they are self-reversing at some future stage then we accept that.

That is one of the reasons why, when we established an inflation target, we did not have one of these ones that has got a very hard edge to it, like the New Zealand one. You were supposed to always keep your inflation rate within the band and if the inflation rate went outside the band something terrible was going to happen. People used to say the Governor was going to be sacked or his salary was going to be reduced. We were never in favour of those sorts of hard-edged inflation rate targeting regimes.

We have one, and we call it two to three, but we are not saying you have to stay within the two to three. We are really saying it should average two point something and so if you have a very weak exchange rate which you think is going to reverse, then it is going to actually push your inflation rate up and you will go outside it. If you have a very strong exchange rate for a time, your inflation rate will go down and you might go below it, and we accept that. As long as you are on track in the long run, we do not think you have to make an immediate knee-jerk reaction to the fact that a short-lived movement in the exchange rate is causing your inflation rate to do something you do not want it to do.

Mrs GALLUS—The committee will be happy to hear that, should inflation rise slightly, you do not see that as a pressure to tighten monetary policy.

Mr Macfarlane—No, you are right. With inflation at a low level of two per cent, there is some fat there. With part of the exchange rate temporarily higher than it might otherwise have been because of what is happening in Japan, yes, there is some fat there too.

Mrs GALLUS—Thank you.

Mr WILLIS—I would like to ask you a few questions about economic growth. Your statement indicated that growth was around three per cent in 1996 and you expect it to be more like four per cent through 1997. What is your expectation of reaching the budget forecast of 3.5 per cent for 1996-97 in the light of that?

Mr Macfarlane—You have spoken as a former treasurer, I believe. One of the problems with fiscal policy, and I am sure this is one of the obstacles that treasurers have to face, is that they have to do a budget that covers a year and they have to put in that budget what their forecasts are, which is only reasonable because the public wants to know what parameters the budget is based on. Unfortunately, one of the effects this has is that it induces short termism in the way people look at the economy. People see the forecast contained in the budget and they say, 'This is a target. Let's judge how the government is doing by whether they are meeting their target for this year.' You have probably been the recipient of a lot of that sort of speculation in your period as treasurer.

I am always sympathetic to treasurers because I think that there is an unhealthy degree of short termism. I am not actually, at this stage, all that interested in what the figure for 1996-97 comes in at. We are nearly at the end of 1996-97; we have only got a month and a bit to go and we are at the end of it. I think the thing that matters is 1997-98 or, more particularly, what interests me are the two or three years ahead. I have not gone back and done the arithmetic and said, 'What is the chance this thing is going to be met,' because I do not like doing that. As I say, I am sympathetic to all treasurers who find themselves subjected to that sort of pressure.

CHAIR—Mr Willis can take heart from that answer, even though it is the ultimate in diplomacy.

Mr WILLIS—It is a bit unreal to be saying to us that you have not done the figures on what it would be. Obviously you have done those figures and they would be part of the government's considerations on the figure it puts in the budget, so I take it you just do not want to tell us what that figure is.

Can I take you to your explanation in the publication that you have just released, the semi-annual report, for the slowdown in growth in 1996. You say in the report that slow growth in 1996 largely reflected a slowing in consumer spending, which in turn was probably related to weaker employment growth during the year. This strikes me as being a rather circular explanation. Slower employment growth was, of course, related to the fact that GDP growth was down, so we are back where we started. Would you like to expand a bit more on why you think we had slower growth in 1996?

Mr Macfarlane—I think you are right. As it is stated there it is circular, and that is not the full story. My starting point is that most expansions are not smooth. Most economic expansions start off quite quickly at one stage early in the piece, they slow down and then they speed up again. The expansion you are probably very familiar with, the one of the 1980s, was precisely that. Coming out of the recession in 1983, we had exceptionally strong growth in 1984 and 1985. By 1986 we had basically a flat year. Domestic demand was zero, GDP was half a per cent or something, and then we had a further phase of expansion later on which continued through until 1990.

If you went back and analysed the previous expansion, you would get the same sort of thing. There has been a tendency, not just in Australia but also in other countries, for a pause in the middle. You are going to say, 'What caused the pause in the middle?' I think one of the things that contributed to a pause in the middle was the tightening of monetary policy that occurred in the second half of 1994. The economy was starting to grow too quickly, wages were increasing, inflation was increasing and there was a mid-term pause.

I think that probably had quite a lot to do with it.

In 1996 we also had something that surprised me a little bit and that was a bigger slowdown in consumption than we really could have explained. We had about three quarters in a row of very weak consumption, including that big fall in retail trade in the December quarter. You do not normally get slowdowns in consumption of that order, other than in recessionary periods. That has been a short-lived one and consumption has bounced back but I cannot really explain why it happened. I think I can explain why the economy slowed down, why unemployment stopped falling and employment growth slowed. I think it is partly the nature of a business cycle and partly the fact that at some point you have to tighten policy.

Mr WILLIS—Would you ascribe any part of that slowdown to the tightening of fiscal policy and also to the appreciation of the exchange rate that Mrs Gallus has been asking you about?

Mr Macfarlane—Yes, an appreciating exchange rate does have a contractionary effect on the economy, but I think we really had to have a lot of that appreciation because, if you go back to the first half of 1995, the exchange rate fell to a very low level—it fell to an implausibly low level, an unsustainably low level—and some recovery in the exchange rate was virtually inevitable, and we got that. Most of the appreciation of the exchange rate has been a return to normality rather than being an excessive rise.

Mr WILLIS—Fiscal policy?

Mr Macfarlane—Well, mechanically, Keynesian economics will tell you that if you contract one component of public demand the direct effect of that will be some element of contraction. We have always been sceptical about how contractionary it would be, because we had the earlier example, which you would be very familiar with, of the late 1980s, when a contraction of fiscal policy, which in itself was probably contractionary, was more than offset by a big expansion in private investment.

The same thing has happened this time. We have had a contraction in fiscal policy and we have had very strong private investment. I do not know what the net effect of the two is, but it is always true that the narrow effect of a tightening of fiscal policy is contractionary. It is just a matter of how the other parts of the economy react to it.

Mr WILLIS—So do you think it is a factor in the slowdown?

Mr Macfarlane—I am not sure what the net effect of the contraction of fiscal policy plus the strong investment is.

Mr WILLIS—I have just one other question. In the light of that slowdown and the fact that we had much fewer employment growth years than were forecast, do you think that perhaps it could be said that the bank got it wrong on monetary policy in 1996 and that you should have cut interest rates either sooner or faster than you did to prevent that slowdown, particularly the slowdown of employment growth?

Mr Macfarlane—You can always say that. I know that people will say that, but as long as an economy has got some element of a cycle in it, you can always come along after the event and you will see the downward phase of the cycle. You can then turn to the central bank and say, ‘You should have prevented that. You could have prevented it if you had done this loosening earlier or that tightening later.’ And then when you get to the phase of the cycle where it is growing too fast, a group of people will come along and say, ‘Look, mistaken monetary policy—you should have prevented that, you should have tightened earlier.’ It seems to me that as long as economies are going to have some cyclical element in them, and I am assuming that will be forever, you can always make the claim after the event that the central bank could have done something different to have eliminated that cycle, but I think that is a utopian expectation. I think you are going to always have some cycle. You are going to try and be as pre-emptive as you can and that is the most you can expect.

Mr WILLIS—Looking back now with the benefit of hindsight, do you think it would have been better had you made those cuts sooner or larger than you have?

Mr Macfarlane—Well, I have heard people say, "You shouldn’t have had the last tightening". They say, "The easing was great, but you had one tightening too many". We can always go back and try and re-run history, but I think we have had a very mild mid-term cycle. I think it has actually been very successful. In the 1980s equivalent, partly because of external events, the mid-term slowing was zero. Here, we are talking about a mid-term slowing, where growth has gone down to 3 per cent and may for a time be a little bit below 3 per cent—maybe two and a half. That, to me, is a very mild—very mild cycle. Given that cycles are inevitable, the best you can hope for is a very mild one and that has been a very mild one.

CHAIR—Every member of the committee want to ask a question; so I will try and share the questioning around as much as I can. Dr Nelson, do you have a question?

Dr NELSON—Mr Macfarlane, you are predicting 4 per cent growth for the next year. Even with recent modest improvements in savings performance, is Australia’s savings performance sufficient for us to maintain and sustain a 4 per cent growth rate without exacerbating our balance of payments problem and requiring you to tighten monetary policy perhaps 12 months or so further down the line?

Mr Macfarlane—I will answer the second part of that first; it is the easier one. We do not tighten monetary policy or loosen monetary policy because of the balance of payments. Sometimes we have tightened monetary policy when the balance of payments has been deteriorating, but that is because the economy has been growing too fast. Back in 1989, for example, we had domestic demand growing at 10 per cent. So there was a prima facie case on the basis of that to tighten. But the answer is that if the economy was growing at 4 per cent, which we regard as being entirely sustainable, but the balance of payments was worsening, we would not regard that as a case for tightening monetary policy. We would think that would be bad monetary policy to tighten in those circumstances. I think that is about as far as I can go, but I can be quite emphatic on that one.

Dr NELSON—Do you feel, though, that we can sustain 4 per cent without exacerbating our balance of payments problem?

Mr Macfarlane—The balance of payments may widen. But I think, again, in answer to you, as I answered one of the previous questions, there is a bit of fat there and there is nothing that says that it is going to be a disaster if the current account is wider than it is at the moment.

Dr NELSON—The second question is, I suppose, one that ordinary Australians ask themselves frequently. If a sustained expansion in the economy is the principal solution to unemployment, why, after six years of sustained expansion, do we have 8.7 per cent employment trending up a little bit perhaps in the last year. I realise there are complex reasons for that, but it is something that people understandably question?

Mr Macfarlane—That is a very good question; it is a very big question.

CHAIR—We might want to come back to that question, because a lot of people want to ask questions along that line.

Mr Macfarlane—I am very happy to answer it and the answer is quite a long answer.

CHAIR—There are a lot of questions on it, but I think we are looking at monetary policy at the moment; so Mr Pyne, is next on the list.

Mr PYNE—Mr Macfarlane, the Australian financial market has followed US monetary policy very closely and you said in your opening statement that the UK and United States have been tightening monetary policy in recent times in response to various factors. Would you like to elaborate on the implications that that has for Australia's own monetary policy and interest rate sentiments?

Mr Macfarlane—It has an implication, but we really mainly conduct monetary policy on the domestic needs of the economy. It has an implication and it can have quite a big implication at certain periods. For example, in the mid-80s when we were terrified about what was happening to our exchange rate all the time—everyone in the world seemed to hate the Australian dollar and they were always trying to find an opportunity to dump it—international considerations became almost paramount in monetary policy decision-making. But I think one of the advantages we have got for ourselves and bought for ourselves in the 90s—as a result of having had what, by international standards, is regarded as an extremely respectable economic performance and extremely good inflation rate, lower long-term bonds, more stable exchange—is more independence, more freedom to act in terms of what we think is needed for the domestic economy. Although in extremis, we have to take account of what goes on around the rest of the world. But we have definitely got more freedom to act independently now.

Mr PYNE—Is it possible that down the track we might have a situation where we have a low inflation economy but high interest rates, because of world interest rates being high?

Mr Macfarlane—It is possible, but I do not think very likely. I think one of the other things too that is worth bearing in mind is that in the bad old days, not just in Australia but other countries, we used to have to move interest rates by a very large amount to have some effect. But since we have reached the 1990s—the low inflation 1990s—the movements are much, much smaller here, and even in the US. One of the great virtues of the stability that has been achieved there is that with relatively small movements in interest rates, the economy has been able to—again it has still got a cycle; you cannot get rid of the cycle completely. You do not have to have these big lurches in interest rates. There are much more smooth, almost fine tuning type changes, in interest rates. So I would not foresee a dangerous scenario of a world interest rate structure that is so high that we have to match it, even though we have got all sorts of domestic problems. I do not foresee that scenario.

CHAIR—I just wonder on that last point whether, if there was a major correction on, say, Wall Street, you are sure that that would be the case.

Mr Macfarlane—Well, you are right. It is another example of our interrelationship with the world market, but I think it would work in the opposite direction. If there was a collapse on Wall Street, that would be a contractionary effect for the world economy and, other things being equal, that would lead to lower interest rates in the US, or it would mean they would not want to put them up. Whatever it is, it would mean lower interest rates. So that would have the effect of transmitting to us a tendency towards lower interest rates.

Mr HOCKEY—Following on from that, do you think that the extraordinary growth in the equity markets is sustainable to the Australian economy?

Mr Macfarlane—I think that the Australian economy has not been that extraordinary. It has been healthy. I think we quoted a figure of 25 per cent over the last two years. The one that is extraordinary is the US. I often get asked this question and every time I have answered it I have got the wrong answer. I have always thought it has gone so far, surely it cannot go any further. I always say that I am pleased that I am not a funds manager. I guess I probably would not have my job, if I was.

Mr HOCKEY—People would probably be hedging your answer.

Mr Macfarlane—When Alan Greenspan speculates about the Dow, it has an effect on the Dow. I think anything I say would have no effect on the Dow, so I have got a bit more room to move. I really cannot claim to have any more expertise—I would say less expertise—on that subject than the private sector funds managers, half of whom get it right and half of whom get it wrong.

Mr HOCKEY—Just returning to a question that was asked a little earlier about the government's fiscal position, particularly in the last 12 months. You say in your opening statement that we have seen marked falls in interest rates over the past year, not only at the short end, but also in the longer term rates, which are set in the capital markets. You also say the yield, for example, on 10 year bonds has fallen by over a 100 basis points and this reflects the improvement in the government's fiscal position in the falling inflation. Given the government's commitment to further reduce the budget deficit and with what is mooted as probably a zero increase in the level of net debt issues by the Commonwealth for this coming year, do you think that there is room for longer term interest rates to continue to fall and do you see the spread between the US and Australia continuing to narrow?

Mr Macfarlane—I think the answer to those is yes, but by how much? You would not want to sit waiting on the edge of your seat. These things take a long time to occur. You are going to hear that theme again, I think, as we go through this meeting. The good things you want do not occur quickly. They always take a long time. We have got that graph which is on page 29. It shows the difference in the yield between an Australian bond and a US bond. At any particular point there, you would be wondering whether we were making progress. But when you actually graph it over 10 years, you can see that there has been very significant progress made there.

Basically, there are two most important considerations behind that. Australia has returned to having an internationally respectable inflation rate. That is number one consideration. Number two consideration is that Australia has moved towards being in the better half of the world, or better quarter of the world, in terms of its fiscal responsibility. We are not like the Europeans. We do not have those big budget deficits the size they do in Europe and I think we have got a lot of international creditability over that 10-year period through both the improvement in our inflationary performance and the improvement in our fiscal performance, although with the fiscal one, it is not a continuous improvement, of course. It has come in a couple of spurts. Both governments have had periods where they have made significant improvements in the fiscal performance. So I think if you look at any of these things over a reasonably long period, what you are talking about will come true.

Mr HOCKEY—Given that in your opening statement, you emphasise the fact that we really, as a nation, should be looking for long-term stability in our economic direction as opposed to the volatility of economic cycles that we and other international economies have experienced over a period of time, how important is it for the government to set down and keep to long-term fiscal objectives and having in place a sustainable budget surplus?

Mr Macfarlane—I think it is very important. I think it is extremely important. I think every country has reached that conclusion, but the difficulty has been in the execution and we have done better than most, much better than most. That does not mean you always have to have a balance every year or a surplus. It means that on average over a long period you should be aiming for some sensible thing like the balance in the budget or that the tax revenues fully cover recurrent expenditures, or whatever it is. You should define something as being what you want in the long run. In the short run, you keep getting back to this thing called the business cycle. There will be a business cycle, and in the short run there will be some variation around that. In the strong years you will be in surplus and in the weak years you will be in deficit, but I think that is a perfectly sensible way of approaching fiscal policy. I think there is just widespread agreement that that is what you do with fiscal policy. You allow the automatic stabilisers to work but they work around long run stability, a long run situation where this generation pays for itself and does not put the burden onto the next generation.

Mr ALBANESE—I wish to pursue the questions put to you by Mr Willis. Is it not the case that, given the tightening of fiscal policy we have seen occurring, you did too little, too late, if you like, in terms of the loosening of monetary policy last year, particularly in the light of lack of employment growth?

Mr Macfarlane—I think you are just asking the same question. You are not really exploring it, just asking it a second time.

Mr ALBANESE—You did not answer it before. I thought you might answer it this time

Mr Macfarlane—I think I did. I did answer it. I do not think we were. I think we did as best as is humanly possible. I am saying that the problem is, however, that even if you had superman doing the job, as long as there is still a cycle someone will be able to come along and say, "You should have eased earlier". I am saying that, alternatively, someone could say, "When you did the tightening in 1994 you tightened too much," or "You shouldn't have done the last tightening." I do not think we are ever going to find a world where monetary policy can be so fine tuned that you will not get the sort of mid-term slow downs that we have had. We have had a very mild one, by any historical performance and a very mild one by international performance.

Mr ALBANESE—That depends where you are sitting, of course, but in terms of putting the facts in another way, in the February *Reserve Bank Bulletin* it was stated that the underlying employment growth seems to have picked up. We will get the new figures in about two minutes, but certainly given the March 1997 figure of 8.7 per cent unemployment, given your own document distributed today, which talks about a flat level of full time employment growth—in fact if there is any growth at all in employment it has been in part time growth—did you not get it wrong in February 1997 in that report?

Mr Macfarlane—It is explained here that basically in a sense we did get it wrong, because the Statistician got it wrong. The Statistician changed the way in which the labour force survey was done, and then explained that this change had led to an under-estimate of employment growth, told us how much you should add back on to get the real figures and if you did that you actually had quite a substantial pick up towards the end of September and in the December quarter. Now we are told that that is not true; that has been revised away again and so we are back onto the sort of pattern that we had been thinking was the case before we put out that February statement.

CHAIR—We might hold questions on unemployment given that that release is imminent and come back to it. Mr Wilton has a question on monetary policy.

Mr WILTON—Mr Macfarlane, you have said that an appreciating exchange rate does have a negative impact on the Australian economy. How significant is that? Are you able to quantify it in any way? Given that much of the product from BHP's Newcastle plant is exported, do you consider that that would have been a consideration in BHP's recent decision?

Mr Macfarlane—I hope I did not say an appreciating exchange rate has a bad effect or depressing effect on the economy, because we have a floating exchange rate and half the time it is going to be appreciating and half the time it is going to be depreciating around a stable long term trend. It is true that during that phase when it is appreciating—pushing inflation down—it is probably squeezing the export sector a little bit, and then it gets reversed when it goes into the downward phase. It is a fact of life which I am sure Australian business is comfortable with. I have not heard, wherever I have gone, people saying, "this is a terrible thing, having this floating exchange rate, because sometimes it appreciates and that hurts us". I think basically people know that, yes, it does, but then sometimes it goes the other way and in the long run the whole thing washes out. We have not had any long run tendency for our exchange rate to appreciate or to depreciate. So my feeling is that Australian business has coped very comfortably with a floating exchange rate.

Of course, there are all sorts of other facilities that make it easier for them. You can sell things forward. There is a forward foreign exchange market going out as far as five years; so I am very comfortable with our exchange rate regime and I believe that the Australian business community is comfortable with it.

Mr MUTCH—I believe that employment has risen by 37,100 in April and unemployment was persisting at 8.7 per cent. Would you agree that you have ample latitude in fact to cut rates again, particularly in view of the high dollar in trade weighted terms, low inflation but with a persisting back-log of unemployment. The Government has been very responsible on fiscal policy. Does that not give you the opportunity to be less cautious than you seem to be on monetary policy?

Mr Macfarlane—In the first part of your statement you were telling us what the figure for April is. There is an increase of 37,000 in employment in April, is that right?

Mr MUTCH—I believe so.

Mr Macfarlane—Good. But the increase in employment must have been matched by an increase in participation rate if the unemployment rate stays the same. I am very pleased to see that there was an increase of 37,000.

CHAIR—You have got the figures there. Do you want to just put them into the record.

Mr Macfarlane—Basically that is right. Employment rose by 37,000 in April which means that the fall in the previous months has been a bit more than offset but the unemployment rate has stayed at 8.7 per cent. It is really a statistical problem almost; 37,000 is a very big increase. If you have a big increase in employment you would have thought under normal circumstances that the unemployment rate would go down. But in our statistics, for some reason, what happens is that they say the labour force has also gone up. In fact, I think 37,000 would normally reduce the unemployment rate by about .2 of a per cent but the figures must say that the participation rate or the labour force has also risen by .2 of a per cent; so you do not get an offset there. That is why we tend to think that the employment figures are actually much more informative than the unemployment figures. We sometimes have the peculiarity in Australia where it is in the months when employment falls that the unemployment rate falls.

The bigger question is, if we have got an unemployment rate as we have in Australia in the high eights, why do you not make another reduction in interest rates, which is one of the things that I covered in my introduction. The answer is that we have considered all those things. We have considered the totality of the economy when we make our decision about monetary policy and we certainly are interested in trying to bring down the rate of unemployment. It is quite clear; we agree with everyone that if you have got inflation of two and a half per cent and unemployment of eight and three-quarters per cent, the thing that needs to be improved is the unemployment, not the inflation. It is the unemployment that needs to be improved. We agree with that, and we believe that the most successful way of doing that is by achieving a long-lasting expansion. So we want to do that, but we have got a very long time horizon. We do not want to be in one-year time horizon or the six-month time horizon or the three-month time horizon. Often when we find ourselves in disagreement with others it is really, I think, because we probably have a less urgent agenda than others. We really want to be judged in two years or three years or five years on how good a job we did.We think we have got the prospect of a long recovery this time. We are looking out three, four or five years and we want to make sure that we manage this one in such a way that we get the longest recovery we can and one that is maybe 50 per cent, twice as long as the sort of ones that we have had in the past. The way you do that is essentially make sure that you have not got any imbalances in the recovery so you can just keep the thing going. At the moment most things are under reasonable sort of control. Certainly inflation looks good, but we have to look wider than that. We have to look further ahead on inflation rather than just the numbers we have got at the moment. One of the things we have to look at which is very important is wages, which I have covered in my introduction.

It is a bit disturbing that the one bit of the recovery, the expansion, that is out of whack at the moment is that we have wage growth which is much higher—well, not much higher, but it is higher than any of the other countries that are running with a 2 per cent inflation rate. If we want to have a balanced recovery, at this stage of the game we should be having lower wages growth than we are getting. Depending on how we read the statistics, wages are either already at a rate which is not consistent with the maintenance of a long-term low inflation rate or they are very close to getting to that phase. So when we look at this expansion which we are trying to maximise for as long as we can, we ask ourselves, do we play for it in the long run or do we try and do something quickly. Our view is that we are playing it properly for the long run. We do believe we are going to have 4 per cent growth over 1997. We do believe that that will continue, and we do not believe that we will gain anything by having another movement at the moment.

CHAIR—I will take one more question from Mr Causley and then we might allow you a couple of minutes break because you have been going solidly.

Mr CAUSLEY—Mr Chairman, I am really going back to interest rates and competition which we dealt with earlier. You said that in fact the mortgage originators had driven down the home lending rates in particular and that that was good news. I suppose I would take it from another angle and say that the mortgage originators are probably working out of the boot of a car and in fact the big lenders, the big banks, have branches right across Australia that they are trying to service, et cetera. So how much of this saving that we are getting in interest rates is illusionary because in fact it is being offset by charges from banks and the closure of branches and the loss of employment?

Mr Macfarlane—I do not think it is illusory. I think you are right to say that when competitors come in with a much leaner cost structure that can offer a price cheaper, then the existing providers have to be able to match them. One of the things they have to do is reduce their cost structure. That certainly is true. That is happening, and the big banks are shedding staff and they are closing some branches, but it does not mean that the reduction in mortgage rate is illusory. It definitely—

Mr CAUSLEY—No, but there is other costs in the community, aren't there, to offset it?

Mr Macfarlane—I think this always happens if someone finds a way of providing a product more cheaply by using less resources, then some of the resources that used to be required to produce that product are no longer required and they basically have to find something else to do. That is the nature of a competitive capitalist society. These things are happening all the time and I think (a) there is nothing we can do about it, and (b) I think it is actually progress even though for every step forward there are a few people who are hurt. I might not be saying this if I was a teller in a bank or I might not be feeling quite so confident about espousing this if I was living in a small country town that just had its branch closed. But on that latter case I think there are ways of alleviating those difficulties. I think we will see expansion of the credit union movement, the post office, a whole lot of other things will step in to fill the breach. But certainly in the immediate effect of it can be quite painful.

CHAIR—I think the committee might take a 5 minute break because Mr Macfarlane has been going fairly solidly for some time now. We will reconvene in 5 minutes.

Short adjournment

CHAIR—We will reconvene now. I would like to move on to wages policy but before doing that Mr Hockey says he has one very important question that he would like to ask Mr Macfarlane. We unfortunately lost a little bit of the recording because someone inadvertently turned off the power. So there has been a small loss but we believe that the switch will be taped up so hopefully that cannot happen again. Mr Hockey has one last question on monetary policy and then we will move on to wages.

Mr HOCKEY—Governor, in your opening statement you asked the question, why not keep easing, and then you say part of the answer is that the full effects of the previous three easings are still coming through. When do you think that we will see the full effects completed and do you have any view after that?

Mr Macfarlane—I am not sure when we will see the full effects. People talk about monetary policy having long and variable lags. Econometricians who try and calculate how long these lags are often come up with quite long periods like a year or 18 months. That is probably about the best I could do. Although I think a fair bit of it comes quite quickly, some of it takes a fair while to come through.

Mr HOCKEY—So what are you still waiting on? Is there any specific data that you are waiting on at the moment to see the final effects of the last three easings?

Mr Macfarlane—No, there is no specific piece of data. The data is continuously arriving and as the data continuously arrives we use that to update our outlook for what we think is going to happen to the economy. I think you would have to say on average the sort of data that we have been getting so far in 1997 has been a good deal better than the sort of data we have been getting in the second half of 1996. We use that to update our forecast of what we think is going to happen and in the light of what we think is going to happen to inflation, output, wages, to the rest of the world. We continuously make an assessment of what we think the needs of the monetary policy are.

CHAIR—Before we move back to Dr Nelson's question about the long term growth and the effect on employment, maybe you would just like to expand on the growth in employment that has already just been announced and the impact you see that having.

Mr Macfarlane—I am not sure there is that much I have to say. It was just that as we were going through the previous discussions I think we were all a bit surprised when Mr Mutch just dropped in a reference to the April employment figures as though we all knew about it whereas in fact he was introducing this very important new piece of information. So he must have very sophisticated surveillance techniques or equipment at his disposal. He should have told us that he had.

Mr MUTCH—Mental telepathy.

Mr Macfarlane—Mental telepathy, is it. I think I have actually had an opportunity to say a few words on that. Basically 37,000 is quite a high figure. We were expecting a high figure. We needed a high figure in fact to establish that employment growth was proceeding at a reasonable rate. So it was a relief that there was a reasonable figure. Employment does tend to lag the cycle a little bit. It is not the first thing; it is one of the last things to turn when an upturn occurs. The first thing traditionally in Australia has actually been the housing cycle. That is the first thing to turn, and employment has been one of the last things to turn.

So it is not as though we are expecting a sudden pick up in employment. We certainly were comforted to see that it is on some sort of track, although at the moment still only moderate growth. But we expect to see stronger growth as we proceed through the year.

So that is really all I wanted to say, just to clarify the information that Mr Mutch put forward. I think I have still got an outstanding question from Dr Nelson.

CHAIR—Yes, I think Dr Nelson wants to ask you that question about the effect of long term growth and the rate of unemployment.

Dr NELSON—I suppose in a sense, Mr Macfarlane, acting as an agent provocateur on behalf of our constituents, if a sustained expansion is the solution in the long term to unemployment why after six years of growth do we have 8.7 per cent unemployment? Can you understand why some members of the community, some of whom I suspect are attracted to the member for Oxley's views, would be beginning to lose confidence in the bank's capacity to find the solution to the problem? I might also remind you that in answer to the question from Mr Mutch you also said that the bank would be judged over a two, three or five year period on its performance. If I said to you five years ago, can we judge you in five years time, and now we have 8.7 per cent unemployment, would you feel that it has been a successful period of management on the part of the bank?

Mr Macfarlane—The answer to that last one is that things that we can influence directly are principally inflation and growth, and I think on the record of inflation and growth we would be judged quite well. There is a whole lot of other things between inflation and growth before we get to unemployment. Can I introduce this by pointing out that I did not say that you could get unemployment down to whatever your desired level is simply by economic growth. I think the evidence is very clear you cannot.

I think that unemployment consists of two components, one which is susceptible to aggregate demand policies and another part which is structural and which is more a function of institutional arrangements. I will give an example of this, if you look over that period—this is actually the last five years—the Australian economy has grown in aggregate over that five years by 20 per cent. GDP is up by 20 per cent. In the United States, which has done very well, their output is up by 14.6 per cent. So our economic growth has actually been considerably stronger than that of the United States.

Having had so much stronger economic growth you would have thought that we would also have stronger employment growth to go with it, but that is not the story. The story is the other way around. With our 20 per cent GDP growth we have had 9.7 per cent growth in employment over that period and the US has had 12.3 per cent So there is something about our institutions that tells us that when we get the growth, sure we get some employment but we are not getting as much employment that some other countries with different institutions can get. So what we have got to do is work on getting reasonable growth, and as I say sustainable growth—not a spurt but growth that lasts for a long while—and that will make a contribution to increasing employment and reducing unemployment. But that is not going to solve the problem in the long run. The problem is much bigger than that.

I think every country recognises that the problem of unemployment is a very big problem, it is a very long lasting one and it takes a long time before you are going to get the result you are looking for. You are not going to just get the result with monetary policy and you are not going to just get it with monetary and fiscal policy. You have to re-examine every policy you have got, every institutional arrangement that affects the labour market, social security system, the education system. You have to look at all those things. We can do our part, and I think we have been doing our part. We certainly want to do our part. We would hate people at the end of the day to say, "The thing that let Australia down was it did not grow fast enough. That is why it has got high unemployment." We do not want that to be said, and that cannot be said.

Dr NELSON—If I could just remind you that when Mr Fraser gave his opening statement to us in November last year he said that the principal solution to unemployment was economic growth. Do you still maintain that?

Mr Macfarlane—I think that was just a shorthand phrase because Mr Fraser knows as well as I know that there are a lot of other things that have to be done. The classic way of looking at this is to look over a broad period, look over the last 30 years, and look across a range of countries. People tend to get pessimistic about unemployment. They think it is inevitable that unemployment has had an upward trend because in most countries it has had an upward trend, but it is not inevitable. There is one country that has not had an upward trend—the United States.

The unemployment rate in the United States now is lower than it was in the first part of the 1960s, 4.9 per cent. It averaged more than that in the first half of the 1960s. It is not inevitable that you have an upward trend. It is likely because most institutions in most countries have tended to contribute to it. But if you look across at the other extreme, if you look at the European countries, particularly the big mainland continental European countries—France, Germany, Spain, Italy—they have got unemployment rates of 10, 11, 12, 13 per cent. Spain has 18 per cent.

Why have they got unemployment rates five or six times what they had in the 1960s and the US has got the same rate of unemployment? If you believed it was all due to growth you would expect to see that US growth was much stronger over that period but it is not. They have all had very similar growth rates. They have all had three recessions and they have all had three expansions; and their growth rates are not that different but the end point for unemployment is totally different. So it is true that the monetary policy has to provide, as well as low inflation, the growth in demand which will be conducive to reducing unemployment. But none of us thinks—I do not think there is anyone in the world who thinks—that the problem will be solved simply by monetary policy.

CHAIR—Having left that hanging, would you like to now expand on what areas of policy that you think have got to be pursued?

Mr Macfarlane—The problem is I am not really an expert on the other areas of policy and I do not want to sort of pontificate.

CHAIR—I think your views will be of great interest to the committee, though.

Mr Macfarlane—It is frightening to know that they will be of such interest. I do think there has been a tendency, particularly for the European countries—and I think in some respects we are a bit more like

Europe in this than we are like the United States—to have an institutional framework which promotes job security essentially. The first priority is job security and to impose lots of conditions and minimum wage conditions and other conditions and usually provides reasonably accessible sickness and unemployment benefits and usually involves a high degree of trade union involvement and decision making. I am just describing a sort of a classic European type economy, and that sort of economy usually also tends to have centralised decision making on wages, which we have moved away from under both governments. So rigid sorts of arrangements rather than flexibility are the sort of things that tend to characterise that sort of economy. At the other extreme, the US type you have highly a deregulated system.

That has some disadvantages and people are often conscious of the disadvantages that go with a highly deregulated system, but the evidence does seem to be there that the deregulated systems do produce better results in terms of lower unemployment.

CHAIR—Just to sort of follow on that. At our last meeting your predecessor suggested he could see no reason why unemployment in Australia could not get down to 5 or 6 per cent. Do you endorse that.

Mr Macfarlane—If you had access to changing all the policies available to you, yes, I would agree. The US is down to 4.9, the UK is down to about 6, New Zealand got below 6 for a while, I think it has just gone up again recently. But none of the European countries is anywhere near that. I think it is possible but it would be a very slow and difficult process because whilst you would gain something in the long run in terms of lower unemployment, there would be other costs that would be associated, and people would probably resist a lot of the things that would be required because they would amount to the withdrawal of a privilege. So I think it would be a very difficult task. My reading of the international evidence is that people who are serious about reducing unemployment usually know that it is going to involve some institutional changes which will be very unpopular. It would involve the withdrawal of some benefits.

Mrs GALLUS—I understand you to be saying really in your references to unemployment that you see you have very little role at present to play in that. Part of your brief is not only to look at inflation but also to look at employment. But everything you have said today has indicated that you feel that monetary policy now cannot influence employment. Would that be true? Am I surmising you correctly.

Mr Macfarlane—Not at all, I said that there were two components of unemployment, one of which is susceptible to demand management—in other words, to the growth of the economy—and another bit which is structural. We can certainly influence the bit that is susceptible to demand management—the cyclical bit—and the way we do that is by maintaining a good long expansion. That is our objective and we do take our mandate very seriously.

Mrs GALLUS—But everything you have said today has indicated that it is the structural problems that you see that are keeping unemployment up and that there is little that you can do on the other one except head for this beacon in the future of sustainable growth. As Dr Nelson has pointed out, we have had some growth but we are not seeing unemployment coming down. I agree you said at the beginning there are two aspects of it, but everything you have said has indicated that you see it as a structural problem and the general feeling that we should be going on a United States route of much more deregulation being the answer to the unemployment problem.

Mr Macfarlane—I think you are being unfair to say 'everything I have said'. In my answer to one question, I did say that, yes, but I talked more broadly about it than that. Certainly in my answer to Dr Nelson's question I said that. I stressed that there were two components to it. I am not for a minute denying that demand management has a very important role to play. That is one of the things that has brought the unemployment rate down from 11.2 per cent to 8.7 per cent. It has played that role and it has got more to do. If the expansion that I envisage continues we will see the unemployment rate considerably lower than it is now. But at the end of the day we will still have to ask those big questions if it is not as low as people would like. We have got to ask those big questions: why is it at that level rather than at another level and we will brought back to some of the structural issues. There is no doubt that monetary policy has a very important role to play. It has played a role and it is going to continue to play a role.

Mrs GALLUS—I am glad we have clarified that. I would not want to have mistaken what you have said, Mr Macfarlane. But if we have a look in the long term you do see some confidence that we are going to get that decrease in unemployment from monetary policy or are you actually saying we will if we get that structural change as well?

Mr Macfarlane—My guess is, if you pin me down and I have to mention a number, that a good sustainable expansion lasting a number of years more, much more than the previous two expansions. We will not do it if we have an expansion as short as the previous two. It has to be a much longer one than the previous two. If we get a good sustainable expansion there is no reason why we should not get it down at least to the low point that it was in the 1980s. So in a world in which, if we have very enlightened demand management policy which leads to a very long expansion, we could see unemployment come down to a number like that. In that case, if you want to attribute everything involving demand management monetary policy, you would be able to say monetary policy has brought it down from 11.2 to 6. I might be wrong; that 6 might be too optimistic. Maybe because we have got a lot of long term unemployed, it is going to be very difficult to get any reduction once you get close to 6. But in principle I do not see that that is out of the question at all. So monetary policy has an extremely important role to play. In fact, I really was slightly disappointed that you characterised my statement the way you did. I was answering one question. It was not the theme of my whole hearing this morning.

Mrs GALLUS—I am please that we cleared that up.

Mr WILTON—The RBA's comfort zone for full time average weekly ordinary time earnings growth has an upper limit of about 4.5 per cent. Can I just ask you how much of that 4.5 per cent is consumed by each of three components or three factors. The first of those being the AIRC's living wage decision, the second of those factors being executives and the like salary increases which according to CED up around the 6 per cent mark across the last year, and the third factor is how much would be of that 4.5 per cent comfort level growth limit would be consumed by the AIRC's decision to introduce a Federal minimum wage?

Mr Macfarlane—That figure of 4.5 per cent for average weekly ordinary time earnings was one that was introduced by Bernie 18 months ago. It was quite a generous figure in a sense. Before we go any further I want to talk about that. It was never intended to be prescriptive. It was never intended to say to any individual person engaging in enterprise bargaining, "this is what you should get or this is what your maximum should be or this is what your minimum should be." It was always intended as a guide for the average that if the average was above that, it was highly unlikely that we would be able to continue in the long run to maintain the sort of inflation rate we have got. But it never meant that a particular industry could not have a lot higher or a lot lower.

In some industries where there is a shortage of skills and there is massive competition to get them amongst firms, clearly you would expect higher numbers particularly if there was big productivity gains. In other industries where there is very little demand for labour or they were shedding labour you would expect smaller increases; so it was only meant to say that at the end of the day after all these enterprise bargains have been completed, we would expect to see on average for the economy something like 4.5 which, of course, includes more than just what is currently the enterprise bargaining sector. It includes the other sectors that you refer to.

You are really asking: what is pushing it up at the moment and what is holding it down? You are right to say that the AIRC's decision on the award stream is not in any way causing that number to push over 4.5. Their recommendation was a very sensible and responsible one in terms of the macro- economic future of the country. There is no doubt about that.

The things that are pushing it up are parts of the enterprise bargaining sector. You mentioned executive salaries pushing it up, although their weight in the total is very small but the increases are higher than they should be in an economy with 2.5 or 2 per cent inflation. Some of the total number is coming from areas that we really do not have very good information on. At the end of the day we do not have good information on all the individual streams that make up the average figure. We have information on some of them and we have information on the average. But I hope that has answered what you said. Most of it is sort of agreeing with the points you made.

Mr WILTON—I appreciate that it is difficult to quantify but some attempt would have been indeed acknowledged and appreciated. I will proceed and ask you about your statement at page 2 of your semi-annual statement wherein you suggested that wage increases under enterprise bargaining continue to be in the 4 to 5 per cent range, figures which appear to be high. Are you suggesting that enterprise bargaining outcomes should be less than 4 per cent? If so how do you reconcile this with the bank's own recent enterprise bargaining outcome somewhere around 4.4 per cent? If you are going to tell me that that was absorbed by productivity increases how in this instance has that been measured?

Mr Macfarlane—I think you are probably right to say that 4 to 5 was rather loose writing. Obviously if we said 4.5 was the appropriate figure we should have used 4.5 rather than the sloppy terminology of 4 to 5. You are right; the bank's agreement was for 4.4 per cent and you ask has there been productivity increases. The answer is, yes, there have been very considerable productivity increases by any measure we can think of. By any measure we can think of output has gone up quite substantially over the last the last year, last five years or last 10 years. But the staff numbers are much smaller. At the moment I think they are about 1,400, in 1983 there were 3,800 people at the Reserve Bank so we have found plenty of opportunities over those years for productivity improvements.

Mr WILTON—Given that it seems that workers under the living wage decision are among the only ones demonstrating restraint across the economy and given also the need for executive salaries to be contained, do you think that RBA executives are setting a good example.

Mr Macfarlane—Yes, I think so. I do not see anything wrong with 4.4. I think that is consistent with all our public statements, 4.4 in an institution with—

Mr WILTON—Executives; that is the word that is stressed.

Mr Macfarlane—Do you mean RBA executives?

Mr WILTON—Indeed.

Mr Macfarlane—We get the same amount as the staff. The increase the same as the staff.

Mr ALBANESE—I wish to return to my pursuit of the employment issue as asked by Ms Gallus. Your responsibilities under the Act are of course to pursue a full employment objective is still in there, in spite of any written agreements between yourself and the Treasurer. I note that earlier on today in answer to Ms Gallus' question you stated that an objective for unemployment should be round about 6 per cent. Is that a Reserve Bank figure or is that just something that is plucked out of the air and how does that sit with your charter.

Mr Macfarlane—It is plucked out of the air. How about that. The danger in any position, and more so in a budget, is whenever you mention a number someone will say that is your target now. I think I mentioned it in the context of over a very long period if you had complete success in running a long sustainable expansion then you should not rule out the possibility that you could at least get back to the lowest unemployment rate you had at the end of the previous expansion, which is 6 per cent. So I do not want that to be treated as a target.
It was just there for illustration and if you did achieve that then the growth of the economy would have meant that you came down from a peak of 11.2 to a trough somewhere around six, in which case I think people would regard that as being an extremely successful outcome. As for the actual six, and why it is six and not two as it was in the 1960s, we would be talking about some of these institutional factors again.

Mr ALBANESE—Do you see your employment objective being a contradiction in any way to what appears to be, from what you have said today, the primary objective of a low inflation target? Do you see any contradiction between those two aims?

Mr Macfarlane—No, I do not. I do not at all. In fact, I think low inflation is absolutely essential if you want to get whatever maximum benefits you can on unemployment. In the long run, the only way you can sustain a long expansion is if it is a low inflation one and that will get you whatever the best figure is that you can achieve, given our current set of institutions for unemployment. You are right to say that if it turns out that the very best you could hope to get is six, someone could come along and say, 'But that's not good enough', because in Australia, by full employment we mean full employment as we meant it back in 1959, when that act was written and we really mean we would not let you off the hook unless unemployment was two per cent or 1½ per cent as it was then. That would literally be true. The act does say 'full employment', it does not say 'employment', it says 'full employment'. What it means to us is, 'Do the best you can with monetary policy. Deliver in the long run what monetary policy can deliver,' and I think that would be in keeping with the spirit of the act.

CHAIR—Just on that point, Professor Krugman in an article in the *Economist* last year, suggested that if you pursue this low inflation very hard, you are likely to do it at the expense of reducing unemployment to some extent. What are your comments on that?

Mr Macfarlane—Certainly, in the short run, if you are looking over a period of a year or 18 months, there is a trade-off between inflation and unemployment, but I know the article and I know a lot of Professor Krugman's writing and Professor Krugman is not suggesting for a minute that, in the long run, you have got a choice between low inflation and high unemployment or high inflation and low unemployment. Because if there was that choice in the long run, I would take the high inflation, low unemployment.

CHAIR—That is what the choice was, very low of low, was it not?

Mr Macfarlane—I think what he was doing was being critical of the Bundesbank, essentially. I think Professor Krugman feels that some of the European central banks have adopted an excessively zero inflation model—kill inflation at all costs—and he was contrasting them very unfavourably with the Fed, which has a more pragmatic approach, as we do.

Mr ALBANESE—You have emphasised, both in the document which you have given us—your semi-annual statement—and in your answers to questions before the committee, that institutional arrangements are the big barrier to employment growth. Is it the case, given the stress which you have placed in your report on wages growth, that in your comparison with the United States as being an example of somewhere Australia could head, whilst there has been significant employment growth and there is a lower unemployment rate than perhaps in Europe, that that has been at the expense of creating a new class of working poor? Is it the case that all the benefits of the economic growth in the United States have essentially been to the high income earners and that real wages have been stagnant for two decades or more in the United States? In terms of the employment growth which we are seeing today, and I have not had Mr Mutch's advantage of telepathic figures being given to me, part of the explanation for unemployment staying higher at a time when employment has grown is that the employment growth is in the low wage, part-time casual area. That is something that is emphasised in your report. Is that really the road that you wish to see Australia go down?

Mr Macfarlane—I accept that the purely deregulated path does have some shortcomings. I think the community has to make a decision and I would not want to make the decision for the community. We should be aware that if we said that low unemployment was the absolutely overriding consideration, it was more important than anything else, at the moment the only model that has found a way of doing this is the United States. It is true that, for example, its minimal wages are extremely low, so a lot of people there work at wages which we would find unacceptable in this country. It is true, and I am not sure whether this is necessarily connected to the deregulation of the labour market, that in the US corporate sector there are some excesses, which I personally would not like to see. The sort of salaries that US executives pay themselves seem to me to be quite unbelievable and totally undesirable. I do not know whether that is a function, though, of the deregulated labour market. I am really talking about wage and salary earners. It is an awkward choice that people have to make, but I think they have got to be prepared to look at it and realise that that is the choice: that if you really want to have the sort of unemployment rates you had in the 1960s you would have to go back and undo a lot of other things that have been done since the 1960s. We may not wish to do it, but we should be aware that those are the sorts of choices that we have to look at.

Mrs GALLUS—Just on the lower wages—and that is a choice in that they are very low in the United States—is it not also true that they can bear lower wages because they have a much higher tax threshold? Does that not affect what you can do with low wages?

Mr Macfarlane—I am sorry, I do not really know enough about the US tax system to answer that.

Mrs GALLUS—The tax threshold in the United States is over $20,000, and that is excluding social security taxes. They have a different tax threshold which allows them to bring down those wages further.

Mr Macfarlane—It is an interesting point that you make. As I say, I do not know, but it shows that all these policies do end up becoming interrelated. It is not just a matter of pointing to one policy and saying, 'This policy will solve it.' You cannot just look at monetary policy or fiscal policy and say that that is going to solve the problem. You have to ask why and you have to look at wages policy and social security policy. You have just introduced another example where you probably have to look at tax policy and you certainly have to look at education policy.

Mr ANTHONY—You are highlighting the difficulties of the choice between low inflation and relatively high levels of unemployment or perhaps tackling unemployment first to the detriment of inflation. What rate of GDP growth in Australia do we need to see before we can really start cutting into the unemployment rate? Should we be trying to aim at some of our Asian neighbours' rate of six per cent or above? Secondly, within the wages structure, in your report you say that manufacturing is one of the weakest sectors in the Australian economy. Of course, that area is where we have had some recent enterprise bargaining, with five per cent gains in the industry sector, at least in the metals industry which tends to set the benchmark. Will that eventually be counterproductive to an already weak sector, and could we see a wages explosion in an area that needs assistance?

Mr Macfarlane—The answer to the second part is easier. I think that it has actually already caused quite pronounced problems in the manufacturing sector or the metals sector. Manufacturing output has been essentially flat for a couple of years. Manufacturing employment has been essentially flat and manufacturing prices have been essentially flat. So the fact that wages have been going up by five per cent has not actually caused inflation. We know that, because we can see the manufacturing prices. It has led to this weaker growth of the sector and weaker employment. I think that is quite clear.

That is not true of the economy as a whole. I am not trying to claim that it is true of the economy as a whole, but the economy as a whole has to grow fast enough so that it absorbs the entrants into the labour force. Of course, productivity also has to be taken into account. If the economy can grow at three per cent and if productivity is one per cent, then employment will only be growing at two per cent. These calculations are quite sensitive to what is happening to productivity and what is happening to the labour force. But normally, a 3½ or four per cent growth would have the effect of reducing unemployment somewhat.

Mr ANTHONY—But to have a significant reduction do we need to have a couple more per cent?

Mr Macfarlane—It is a matter of the time frame you want to do it over. You could do it, but the length of time is also crucially important. If you can have a sustained expansion, you are going to get gains year after year after year. Maybe it is not going to be as big a gain as you had in one year if you had a very big spurt, but the big spurts do not tend to last.

Mr ANTHONY—You raised the issue, which has been raised by others of the committee here, that institutional structures need to change before we can start addressing unemployment issues. Could you just make some comment on the call now, which is happening in many sectors of the community, regarding tax reform. What are your views and what sort of impact might that reform have?

Mr Macfarlane—I think I will give that one a miss, if I can. I think the point is correct, as raised by Mrs Gallus, that all these things are interconnected and taxes may well have a role, but I do not think it is at the forefront. Really, what I am trying to say here is that nothing should be sacred. You have to look at every policy and ask, 'How can we improve it in order to reduce unemployment?' You cannot just give the task to one policy area and say 'Get on with it.' You have to look at the whole range of policies.

Mr WILLIS—I just want to ask you about the statement you made in your introductory remarks about wages, and particularly your comparison with Mr Greenspan. You were hoping that you would be in the same position as him, being surprised by some good wage numbers. Have you not in fact been surprised by some bad wage numbers in terms of the scenario you have been setting out for appropriate wage expansion here today? Given that that has happened at a time when the economy has been growing relatively slowly compared to what you expect, does that not mean that the outlook for wage increases is for them to be higher rather than lower and, if that is not the case, why isn't it?

Mr Macfarlane—We are on a learning process, I think. We have the labour market which was highly centralised—wage fixing in Australia was highly centralised for decades really, for 80 years or whatever it is—and in recent years we have moved away from that. Not just under this government, but also under the previous government, we moved away from a highly centralised system towards one which has more decentralised elements in it. In any learning process, people will probably handle the new system clumsily and I think that what we have seen over the last three or four years is some of the participants not really being on top of what is required under the new system. It is probably true to say that management has been weaker in adjusting to the new system than the union movement.

A lot of managers in Australia assumed you did not have to worry about wage bargaining, it was not part of your job. It was something that was handed down centrally and you just got on with it and did the other part of what was involved in running a business. So in the early days, I think we have seen management paying insufficient attention to wages. It was just delegated to the personnel manager and the personnel manager accepted that they paid whatever the going norm was in the industry. But now we are seeing people coming to terms with the new system and realising that if they do not do that part of their job well, then the business is not going to run properly and in extremis, the business is not going to be there at all. We are now seeing in Melbourne at the moment—for example, in the Email situation, a management which is realising that it has to actually take an interest in this issue and come up with a wage outcome which is consistent with the actual prospects of the firm. I am assuming, and I might be idealistic about this, that this learning process will continue and that it could well be that the peak of enterprise bargains has been reached and they start to come down.

Mr WILLIS—Isn't the evidence that this learning process, as you call it, is not showing up in the way of any lower rate of wage increase? In fact, the last figures we just had recently showed an increase in the annual rate from 3.9 per cent to 4.6 per cent, so it is a considerable spur to the time before the economy really gets going again. Doesn't that suggest that, rather than a learning process, at a time when the economy has been relatively flat wage increases have taken off and in those circumstances you would expect them to be even higher if the economy gets a real head of steam?

Mr Macfarlane—I think it would be right to say that the recent March quarter figures showed an increase compared to previous quarters. It certainly is disappointing that, in an economy like ours, we should be experiencing higher wage growth than other countries in a similar position. As I say, part of the explanation for that is that we are in this learning phase and I think people will wake up to it. Inflation is going to stay at two or 2½ per cent. So, unless you have got very high productivity growth in your industry, you just cannot keep on paying five per cent. We are seeing the signs of that but it has not shown up in the figures yet. You might be right, but I sincerely hope you are not.

Mr WILLIS—We did have an accord which put a framework around things. Now we don't have that and so people basically have been able to do what they think they can get away with regardless of what the overall impact might be, but presumably that is the system which the government deems appropriate. But in the circumstance that we have wage increases pushing up, if they were to push up further as the economy got stronger, what would you see the implications of that being for your forecast of four per cent growth in 1997?

Mr Macfarlane—If wages push up further and wages get out of control there will be no alternative but to tighten monetary policy and there will be no alternative but to have slower growth of the economy. That would be the classic choice between, 'Do you want to have higher wages for those in employment or do you want to have an economy growing that creates jobs for other people?'

Mr WILLIS—So the four per cent forecast depends on wages staying pretty much where they are in terms of rates of growth. Is that right?

Mr Macfarlane—Yes.

CHAIR—If there are no further questions on wages policy, has anyone got any questions on related matters? I thought we might now move on to the Wallis report because I think there are quite a few members who would like to ask questions about that.

Mr Macfarlane, could we start off by looking at one of the key sections of the report, particularly as far as the Reserve Bank is concerned: the separation of prudential supervision that is recommended. I will just preface that by saying that this report has been sent to the Treasurer and the Treasurer has not responded, so obviously it is not binding. If prudential supervision was given to the Australian Prudential Regulation Commission, or whatever it is going to be called if it does come into existence, would this in some way weaken the safeguards for depositors in various banking type financial institutions?

Mr Macfarlane—Before I answer that question, I would like to point out that I have not yet had an opportunity, although I will, to have an input into the Treasurer's deliberations on which recommendations of the report he wishes to recommend be taken up by the government. Given that I have not had the opportunity to provide my private advice, I do not want to start public controversy by arguing publicly against positions which I have not yet had an opportunity to mention privately. That being said, we do have on the record the published submissions that we put into the Wallis inquiry, and so anything I say here today will simply be to state some of the things that we already have on the record.

The first thing I would like to say is that I think the inquiry did a remarkably good job considering the time they had available to handle such a huge subject. They came up with a large number of recommendations—115, I think. We would have no difficulty whatsoever with almost all of the recommendations that they came up with. In fact, the only part that we do have any difficulty with is the part that we had already clearly flagged in our submissions. They propose a system which would work; they have a system that is a viable alternative. It is not the one we would prefer but it is a system that could be made to work. They propose a system which meets the particular objectives that they thought most important when they sat down. The particular thing that they felt most strongly about, I think, was what we would call competitive neutrality. They wanted to make sure that all financial institutions by and large were treated as equally as was possible. They regarded that as a very high priority.

One of the reasons that they were led in that direction related to some of the things that people have said around here today: that they thought the banks were actually getting too good a deal out of the system, and so they have proposed a system which they think is more neutral. It would involve establishing a new bureaucracy which would consist of parts of the present Insurance and Superannuation Commission, a part of the Reserve Bank and a part of AFIC, the Brisbane based institution that supervises building societies and credit unions. Such an institution might be termed a mega prudential regulator because it would supervise banks, building societies, credit unions, friendly societies, life offices, general insurers, superannuation funds and hence a large part of the funds management industry.

That is a model that could work. I think there are some countries which have a model—some of the Scandinavian countries—that look a bit like that, but it is not the model that we favour. We feel that we are more comfortable with a model where a central bank supervises the banks.

CHAIR—I respect the qualifications you have put on that answer; nonetheless, I would like to pursue it again. If the Reserve Bank were to be merely looking after systemic stability, I think is the term, and the majority of the deposit taking institutions, to get my terminology right, would come under a different regulator in effect, how would that add to the security of the depositors? Notwithstanding cross-overs of boards and all sorts of things, they would be a little bit at arm's length. In the past you have had a situation where, if a bank got into trouble, the Reserve Bank was generally pretty quick off the mark because you knew what was going on and you could deal with it in a way that did not cause distress to the depositors.

Mr Macfarlane—The authors of the inquiry have actually, I think, gone out of their way to try to deal the Reserve Bank back into a lot of those functions that a central bank, bank supervisor would normally do. The structure they have in mind has the three members of the Reserve Bank being on the board of the new super prudential regulator, APRC. It would have all the information that was collected by the APRC being made available to the Reserve Bank, it would enable the Reserve Bank to go on any on-site visits or inspections that the APRC did of a deposit taking institution. It also says quite clearly in its recommendations that the Reserve Bank would be responsible not only for monetary policy but also for what is called financial system stability, which is not the detailed supervision of each institution but a responsibility to make sure that, if a failure occurred, if it were a big enough failure to actually threaten the stability of the financial system, then the Reserve Bank would step in and do something about it.

The outline which the Wallis inquiry came up with does have, in a sense, the Reserve Bank shadowing the APRC. If we were to do it absolutely literally, we may well be duplicating a lot of the work that would be done by the APRC, but it leaves that option open. If we are very serious about taking responsibilities for system stability, we would probably need to almost be a second bank supervisor.

CHAIR—Can I come from another angle then: the head of one of the major banks expresses considerable concerns about the security for depositors. Do you believe that this system will improve the security or at least maintain the security that depositors currently enjoy or believe they enjoyed?

Mr Macfarlane—It depends. In principle, the quality of supervision could be the same. In principle, if a new institution—I do not know how it will turn out because it is new and untried—were created it could supervise as well as the Reserve Bank supervises. Even though it would have a wider range of institutions to supervise, it would have to look after the credit unions and the building societies, many of which are quite small and regionally based and which would require quite detailed supervision. On the basis of simply the change in structure, I do not think we could necessarily assume that the supervision would be weaker for the building societies and the credit unions than it is at the moment. I think that is probably drawing quite a long bow. It depends on what promises are made to the depositors of those institutions.

CHAIR—I was suggesting other than the credit unions and building societies. Can I put it another way then. If you have got this fairly complex crossover of boards and so on, will that enable a speedy response were there to be a problem detected, as you probably feel you would have at the moment, particularly how you can make a fairly quick response?

Mr Macfarlane—No, I think that would be a shortcoming of the new proposal. Even though it would have the advantage of providing more equal supervision, I think one could imagine it being a little bit slower if emergency reaction was required because you would need the coordination of two bodies, because the new supervisor would not have a balance sheet, would not have a cheque book, whereas we would still retain the lender of last resort facility.

Mr WILTON—My question is in a similar vein, and it goes to the issue of separation of prudential supervision responsibilities from the RBA. I know it is a hypothetical question, given that it has not been formalised yet. But do you see that as creating difficulties in assessing the health of the financial sector overall? And, if you were to lose these powers, how does that affect the ability of the RBA to assess an institution's need for liquidity, particularly in its capacity as a lender of last resort?

Mr Macfarlane—I think the thing you are alluding to is that, to do it properly, we would have to in a sense be a second supervisor. To have first-hand knowledge of the health of a particular institution, we would probably have to have quite a heavy involvement along with the APRC, because I think these things always boil down to an individual institution, a queue at the door of an individual institution. We have had three or four instances of that in the last decade. Because we knew the institution was sound, we have been able to make a statement quickly and the people who have been queuing up have gone away.

Mr PYNE—Obviously, Mr Macfarlane, you do not change the current system unless you change a partner for the better or you have as good a system as you currently have. Can you think of any ways in which a change to the APRC with the powers that the Wallis inquiry has given it or would give it would actually change the system for the better?

Mr Macfarlane—If you read the report, some reasons are given as to why they think it would be better. As I said, I think—and there is some legitimate basis behind this—they feel that the banks get an unfair advantage because they are perceived to be safer, because the Reserve Bank is standing behind them. They feel that gives the banks an advantage when they are competing with life officers and funds managers and what have you. So, in that sense, the system would be fairer.

I think there are a few other technical aspects where they think it would be improved. I think they feel that it would be easier to supervise a conglomerate, which is an institution which is perhaps a holding company and underneath it a bank and an insurance company and a fund manager, than the current method which is mainly used here and in other countries of a lead regulator that coordinates separate institutions to supervise a conglomerate. So I think the authors of the inquiry have pointed to a couple of advantages. The question is: do the inadvertent disadvantages outweigh the advantages that they have pointed to?

Mr ANTHONY—We have had the six pillars policy and it will be the four pillars policy next. We have got demutualisation coming up, Colonial Mutual being the most recent and AMP. I am just wondering what your personal view will be in the years ahead. What sort of financial environment will we see under the present arrangement with Wallis? I assume that, with the demutualisation of some of those life companies, they will certainly be in a position to move on some of the existing four banks, and I gather that will be permissible under existing law.

We obviously have got some very large public floats coming up in the next 12 months—Telstra is one, airport privatisation, maybe Fairfax. If we do not get that demutualisation happening where there is a big chunk of cash going back into the economy, that is going to put quite a big liquidity drain I imagine on the financial sectors in Australia, because there will be such an appetite for new capital. What sort of hurdles do you see happening in the next six months in that area?

Mr Macfarlane—I do not really want to comment on competition policy. I only comment on that in so far as it has got a prudential implication. As Graeme has just said to me, there is really only one big demutualisation to occur; the others have already occurred. National Mutual is demutualised, Colonial Mutual has demutualised. The biggest one, of course, of the lot is AMP.

CHAIR—And the NRMA.

Mr Macfarlane—Yes, which is principally a drivers' organisation but with an insurance company as a subsidiary. A lot of money is going to be put in people's hands from the demutualisation of AMP, however, by Telstra shares. I do not know. I really cannot speculate any more, other than to say I think it is going to get more and more competitive as time goes by. I do not know whether it will necessarily become more concentrated, but the markets will just be more and more competitive. AMP have made it clear they want to compete in banking, although they have already done it twice before, but this time they are serious.

Mr ANTHONY—Would it reduce competition if, let us say, there was the ability of one of the four major banks to merge within that stable?

Mr Macfarlane—As I say, I do not particularly want to comment on competition policy because I think competition policy is in very good hands. The ACCC knows what it is doing and Professor Alan Fels knows a lot more about that subject than I do.

Mr ALBANESE—Mr Macfarlane, do you agree with the Wallis report conclusion that there is no reason to exclude mutuals from banking activities?

Mr Macfarlane—Yes, we both said we do. In the past we have been a little bit worried about mutuals because of the difficulty they might have in raising capital. We do not think it is going to be a big issue. We have only got one big mutual left in Australia and it is demutualising. So we will not have any trouble with that. Even if we disagree, I do not think we would have any trouble with that one.

Mr ALBANESE—You would have seen the comments, of course, by David Murray of the Commonwealth Bank with regard to the Wallis recommendations. Do you think there is any substance to the concerns which he has raised which are fairly alarmist, some might say?

Mr Macfarlane—I think I answered that when I answered the chairman. In principle—we do not know about practice; I think he was alluding to building societies and credit unions—it seems to me that there is no reason to believe that the APRC could not supervise credit unions and building societies as well as the current AFIC does.

Mr WILLIS—I think you have answered in your earlier comments a lot of what I was going to ask you, but can I just get a bit more clarification about how you see the new prudential regulatory role proposed in Wallis. You said it would require you to have a substantial duplicatory role so that you can respond appropriately in your role concerned with the stability of financial institutions. How substantial would that duplicatory role be? What sort of resources would you envisage you would be required to use to duplicate what the other regulator is already doing?

Mr Macfarlane—I do not know. We would have to see what was ultimately expected of us. It is not uncommon to have this sort of duplication: for example, in Germany the institution that supervises banks is not the Bundesbank, but the Bundesbank has responsibility for financial systems stability and the Bundesbank ends up actually having more people working on bank supervision than does the institution which is formally responsible for it. I would certainly hope that situation would not arise here, but that is a possibility.

Mr WILLIS—It does not seem to fit with a system that is supposed to be producing more efficiency to build in a duplicatory role for a body which is not the immediate prudential supervisor. But, given the problem that that creates, how would you see overcoming the problem that clearly the Wallis inquiry was trying to get to, which is the problem of convergence of products—that is, the banks offering fund management type products and insurance companies offering banking type products? How would you see that being dealt with other than by the approach that is being put forward here?

Mr Macfarlane—Basically by the present arrangement of the lead regulator.

Mr Thompson—I think the current system is handling those sorts of developments fairly well. One area where, as we said in our submissions, we would see some merit, if the government wished to do this and if the states agreed, in bringing regulation of several institutions together would be to bring all the deposit taking institutions under the one regulatory roof.

I think the extent of overlap between the sorts of products that deposit takers are offering on the one hand and that insurance companies are offering on the other can be overstated and has been overstated a good deal. There is some overlap, but it is not extensive, and we would not see it increasing dramatically. To the extent that it does occur within financial conglomerates where you have a bank and an insurance company and perhaps a funds manager, we feel that the issues that arise there can be dealt with through the current Council of Financial Supervisors—perhaps with more formal powers that it currently has and, under that Council of Financial Supervisors, a lead regulator arrangement for conglomerates where one of the relevant regulators has delegated responsibility for oversight of the group as a whole, while the individual regulators continue to look after their own particular areas of expertise.

Mr WILLIS—You say you do not expect this convergence issue to become much more extensive. Why do you say that? That seems to go against the assumption behind this report and, I guess more broadly, in the community that this is going to be a rapid and substantial development.

Mr Thompson—As I said, I think the extent of that has been overstated. I do not think it is happening to the extent that some people often describe. I think it is probably fair to say the members of the committee appear to see this becoming more significant through time. I think your word 'assumption' is a good description of that. I do not see that necessarily happening. I think the forces for a specialisation within the financial system are also quite strong.

Mr WILLIS—Also, are you at all concerned about the prudential regulator covering not only all deposit taking institutions but insurance and superannuation funds as well? Are you at all concerned that that might put in the minds of the consumer the assumption that the protections which apply to deposit taking institutions apply also to insurance and superannuation funds who are more fund managers than deposit taking institutions and, therefore, provide an assumption of Reserve Bank backing for these funds which currently does not exist?

Mr Macfarlane—The thrust of the submissions that we put into the inquiry was that there was this danger that people would think the government underwrites everything. I think the inquiry people would say that is a function of what you put in the legislation, what particular promises you make and do not make when you write the legislation. I think that would be difficult to be able to define and come up with a form of words so that the average member of the public knew precisely which things they were taking the risk on and which things the institution was guaranteeing. It is a very difficult subject. However you do it, it is never going to be completely satisfactory.

CHAIR—Mr Macfarlane, could I just follow up on that point in another aspect. If you move towards the prudential regulation commission and give them, if you like, supervision over a wider range of financial or deposit taking institutions, does this in some way diminish the opportunity for the Reserve Bank in its control of monetary policy? For example, housing interest rates: at times you may have made a particular decision on that. Under this would it reduce or diminish your opportunities to have a direct input there?

Mr Macfarlane—I do not think so. I do not think it really would interfere with our capacity to carry out our monetary policy.

Mr HOCKEY—Governor, do you have a view about the opening up of access to the payment system to non-banks?

Mr Macfarlane—We basically agree with the recommendations of the inquiry.

Mr HOCKEY—On a separate note, do you have a view about the fact that banks seem to be relying more and more on wholesale funding as opposed to retail funding at the moment?

Mr Macfarlane—I do not think it concerns us. There are some banks in the world, for example, that rely entirely on wholesale funding. The big money centre banks in New York rely entirely on wholesale funding. A regional Australian bank, a state bank, relies entirely on retail deposits. I think it is really up to the management of a bank to decide what is the optimum mixture for their business.

Mr HOCKEY—I suppose what I am leading to is: what does it mean for competition for the retail dollars?

Mr Macfarlane—I think there are still plenty of people competing for your money. Are you alluding to the fact that, if you are a depositor, deposit interest rates of banks seem to be pretty low at the moment? Part of the explanation for that—in fact, I get more letters written to me complaining about low interest rates than I do about high interest rates; half the community are complaining about these low interest rates on their deposits—is that we are in a low inflation environment and interest rates should be low. But another part of it is that, as I mentioned earlier on, during that period in 1994 when monetary policy was tightened, we effectively lifted the short-term interest rate structure up by 275 basis points but the banks did not move that distance; they only moved 175 basis points. At that time they took an action which gave their borrowers a good break but not their depositors a good break. I do not know whether that was the right thing or the wrong thing, but certainly I think the borrowers, and the small business borrowers, are probably quite happy about that.

Mr HOCKEY—I suppose that leads on to the next question which you raised in your opening statement about mortgage lending not being as profitable for regional banks as it is for some of the larger banks and therefore the regional banks are being more competitive in small business lending. I am wondering if you could expand a little bit further on that.

Mr Macfarlane—I do not think I am saying that mortgage lending is less profitable for regional banks than for major banks. What I was trying to say was that some of the regional banks, because they were former building societies, relied exclusively on mortgage lending, so their product mix was not very varied. They had all their eggs in one basket, which was basically mortgage lending. When the competition came into that area and squeezed the profitability out, for a major bank it did not matter so much because it had three or four other strings to its bow, but for a regional bank which was relying exclusively or almost exclusively on mortgage lending it put the squeeze on them. I think it made them realise that they would have been better off with the more diversified product mix than one that relied almost exclusively on mortgage lending.

Mr HOCKEY—Finally, Mr Chairman, I suppose when we look at the level of competition in banking and consumer perceptions of banks until now, given that the Reserve Bank is a prudential supervisor of banking institutions, there is a market perception and perhaps an international perception that all banks at the end of the day have an implied guarantee from the Reserve Bank and from the Commonwealth or from state government. We have actually seen since 1930, I think, basically governments bailing out banks. Do you think the recommendations of the Wallis report will finally put an end to perceptions of an implied government guarantee for financial institutions of Australia?

Mr Macfarlane—When you say you have seen governments bailing out banks, you have not seen the federal government or the Reserve Bank bail out a bank; we have not done that.

Mr HOCKEY—I am referring to state banks.

Mr Macfarlane—What you are seeing is situations where state governments actually owned banks and had a 100 per cent legal obligation to guarantee all the liabilities of that bank that they owned and, of course, they had to bail them out because there was no alternative.

Mr HOCKEY—We can go one step further to non-banking financial institutions and Pyramid—

Mr Macfarlane—That was an interesting test case; and it is not clear, when the dust is settled there, how you define that. Were they fully bailed out or were they only partly bailed out? You are getting into a very difficult area because the public's perception of what stands behind the banks is probably greater than what actually does stand behind the bank. The public perception of why banks have seemed to be safe is partly based on the fact that in the last I don't know how many years—I think it is the whole century (certainly as long as anyone can remember)—in no bank that is federally operating, as opposed to a state bank, has a depositor lost money. That is not because of what is written in the Banking Act; it is just a fact of life that those banks were operated reasonably responsibly and reasonably prudently. You have got to go back to 1979 to find a federally operating bank that even got into any trouble at all, and it was absorbed by another bank and the depositors had no trouble. So that is the assumption that the public has.

If I was a lawyer, which I am not, and I pulled down the Banking Act, I would look through the entrails of the depositor protection provisions. I would not be absolutely clear exactly what they say—and they have never been tested because no depositor in a federally operating bank has actually had to put it to the test—but maybe the thing that matters is not what is actually written in the black letter law. Maybe the crucial issue for the behaviour of the system is what people believe. The current belief has actually provided a great deal of stability to the system but, as non-banks and as the Wallis inquiry would point out, it has also provided a sort of implicit marketing advantage to the banks.

Mr HOCKEY—Do you believe that the Wallis report sends a message to the mums and dads out there that you can no longer assume, or have a view, that financial institutions are backed up by the Reserve Bank or the government?

Mr Macfarlane—The recommendation is that the depositors will have preference, that it will be more clear. Instead of having, as at the moment, relatively ambiguous wording, the Wallis inquiry recommends that the wording be clarified to make it clear that the depositor is given preference and put at the head of the queue.

CHAIR—I think that has been dealt with twice, so we will now go to Mr Wilton.

Mr WILTON—Governor, there are many small businesses in my electorate of Isaacs which often legitimately complain to me that margins over small business lending are still at least 2.5 per cent above the official cash rate. In fact, many cite the example that the overdraft rate remains 6.5 per cent above the official cash rate, even with the security of a first mortgage over residential property. The Wallis report devoted little time to that particular issue, which is of great concern to me, given that this sector provides such a significant part—I think 70 per cent—of the employment. What are your views as to the current problems regarding bank lending in this sector? Are the banks unduly focused on security issues rather than, say, cash flow considerations? And are any of those problems, in your view, due to poor training in that particular area per se?

CHAIR—I think the first two parts of the question have been answered.

Mr Macfarlane—I am not quite sure whether I have answered it to people’s satisfaction. Small business lending is the toughest area of lending, there is no doubt about it, because information is very hard to acquire. We think that competition is heating up there. We conduct a survey of the interest rates for small business loans because we get the same complaints by small business. In fact, we think the complaints had a lot of substance three or four years ago but perhaps less substance now, although there still is some substance in it. With the average small business borrower the rate they are paying is 10.5—well, I think it was 10.6 but that was before the last cut in interest rates had flowed through, so it is now probably going to be something in the order of 10. We produce a publication that shows you what the distribution is. Some of them are getting much less than that and some of them are paying a lot more.

Your question was on the fact that most small business loans are secured by mortgage. That is pretty inevitable too, I am afraid. When you are dealing with really small business, we are talking about loans of $100,000, $150,000, $200,000. The business often consists of nothing more than the principal and a truck or something like that. The failure rate of those small businesses is extremely high. It seems to me the only way that they can reasonably hope to get a loan at all is to have it fully secured. I think the idea of lending against cash flow, for really small businesses, will never happen. The best we can hope for is what happened in mortgage lending and what happened in big business lending, which is just more competition; and I think we are gradually getting there.

CHAIR—Did you want to take us to that part of the question, the training?

Mr Macfarlane—I do not know that I am really qualified to answer that. I have heard people make the claim, and I have heard bank management make the claim too, that it is actually very difficult and requires a lot of training to do that well. Also, of course, the people applying very often come in with no paperwork at all, and there are a couple of initiatives going, run by accounting authorities and others, to help people make a loan application. In fact, I think there are also a lot of small businesses that consist of ex-bank managers in country towns putting out their shingles, and what they do is they help you make a loan application. They make sure you have got the sort of information that a bank manager is going to need. So I think that is gradually being overcome.

Mr CAUSLEY—Mr Macfarlane, I would like to go to the issue of prudential oversight, I suppose, of the system in the future, if you like. The fact is that we are on the verge of a huge revolution, from what I can see, in the whole banking sector. There are predictions that within 10 years there will not be any cheques and we will be a cashless society, et cetera. We are already borrowing over the telephone and we will probably be borrowing on the Internet. Isn't this going to be a huge challenge in this type of very fast world, if you like, to ensure that there is prudential supervision?

Mr Macfarlane—Yes, it is a challenge, although there are two schools of thought here. There are those who think everything is going to change so rapidly that people like us are too slow footed and we do not understand what is going on. There is another school of thought that says some people fall in love with the technobabble so much that they assume things are going to change very quickly. But the public actually do not change that quickly. You mentioned cheques. I am told by a couple of people who were on the Campbell committee, which was about 1981, I think, that they assumed that cheques would have disappeared within five years, because they were hearing the same story about it going to be replaced by telephone banking and credit cards and that the cheque was the thing of the past. But the public are very obstinate and they do things at their own pace, and you cannot necessarily get people to move at the same pace that technology wants to move at. A lot of arguments are still going on about just how fast will these changes be.

The big issue for us is that prudential supervision is really about supervising an institution. You supervise a bank or supervise an insurance company and if new technology arises—for example, the Internet arises—and someone offers you some sort of facility there and asks you to hand over your money to establish an account, are you going to hand over your money to anyone? Or are you going to take a very clear view about who you hand your money over to and only hand your money to someone who you think has got a good reputation and is well supervised and all the rest? Our feeling is that, even though the technology might proceed at a white hot pace, by and large the public—and there will be a few people who are careless—before they commit a fair bit of their wealth to something will want to know whether it is a reasonable sort of place to put their wealth.

If you turn on the Internet and there is the XYZ company who is offering something and next to it are three or four well-known banks that you have known for 50 years who have got exactly the same technology—and they can borrow the technology, or an insurance company as I do not want to give the banks a plug here, or the AMP or someone like that—my feeling is that people might use unknown names for small scale transactions, but I doubt whether they are going to put their life savings at risk—I sincerely hope they don't—if they have got the option between a secure, well-supervised institution or something they have never heard of.

Mr ANTHONY—Just back to small business: we have seen the mortgage rate home originators that have helped drag mortgage rates down. We hope that will happen in small business. I suppose with mortgages it is a lot easier to securitise them and so they can be onsold then. I fear that, no matter what happens, it is going to be very hard to securitise small business loans, and I just wonder what type of environment we will be in, particularly with the budget next week, assuming there is not a call on Commonwealth bonds. Capital is going to be flowing into the corporate market. It might flow into the small business market. But do you think that we will really be able to offer lower small business loans through securitisation? To my understanding, that is probably the only way we will really start to help those businesses, if corporates are wishing to take them up.

Mr Macfarlane—I am a bit like yourself. I am very sceptical about how far they could go. It is happening at the margin. I believe that it is happening in the case of very low risk small businesses. I think I mentioned that before. I think it is happening at the margin. I know Aussie Home Loans say they want to do it. There is enthusiasm there to have a go at it, but I just do not know how successful it will be. It will depend on the default rate of these things. Of course, if the default rate, as we would imagine, is much higher than the default rate on an ordinary owner-occupier or investment mortgage, it is going to be difficult to find people to hold them, once you have securitised them, which is your point.

I think that is not the only avenue for increased competition. I think we have seen competition in small business lending. It is only at the margin of these special products that the banks are coming up with. They are probably not putting a lot into them, but I think they are a bit like the honeymoon loans were three or four years ago. They try to keep it isolated. They try and keep their existing customers not knowing what is on offer, but the existing customers finally wake up and they start shopping around. If they are a very good credit risk and their bank is charging them more than another bank would charge them, they will move.

Mrs GALLUS—Mr Macfarlane, do you think there is any danger that we are almost disenfranchising now part of our society, that is, the people out there who have never heard of Wallis and do not know what in the world Wallis means are faced with a total revolution in the way that they had expected things? Their branches are disappearing where they could go up to the local person and ask what was happening. They are expected to know now for themselves how to do things, what is happening financially. On top of that, perhaps you have lower interest rates, where they are not getting the return for the retirement they want. They look to the equity markets and everybody tells them that the equity markets are going to crash. There is a huge uncertainty of a change of the whole financial atmosphere. Can you see that as having an impact on a sector of the community that is not ready to deal with it?

Mr Macfarlane—I think financial markets are becoming very sophisticated, so sophisticated that I can't keep up with some aspects of it. I get sent a bill to pay and they mention some means of paying the bill that I have never heard of—some new payment system, usually operating through the post office. It is getting very sophisticated. I know that a lot of retirees do not like the fact that interest rates have come down, but I think that has just got to be good for the whole economy. It has got to be good for the future of the country.

Mrs GALLUS—I was not saying whether it was good or bad, I was saying it was part of the whole mix of confusion that is out there.

Mr Macfarlane—Yes. I think it probably is tough for older people, who currently treat a visit to the bank two or three times a week as part of their life. At one stage there was huge opposition to automatic teller machines. My understanding is that people have adjusted to that. There are now more automatic teller machines in Australia than there are bank branches. I can't be sure; maybe there are still a lot of people out there who absolutely hate automatic teller machines.

What you are describing is a microcosm of the whole of society. Everything is changing so quickly. It is like the old-timer who was happy with his local football club and the football club disappears or even the whole football competition divides into two. The world is getting more and more complicated, the pace of change is increasing and financial markets are just one part of that.

This might be the opportunity, though, for some of the smaller institutions that we think of as quite old fashioned to move in and fill the void. I think the credit union movement, for example, has probably been quite successful at moving into some areas where people are more comfortable with a credit union, which they regard as a smaller community based or occupationally based institution. As gaps appear, with a bit of luck other institutions will move in.

Mrs GALLUS—Do we need more than just a bit of luck? Are we really in danger of just leaving those people behind? I think that is a problem we have to face: a class of disenfranchised people from the system. You have to plug those holes or we will have a long-term problem there. Money will start going back into the mattresses.

Mr Macfarlane—We must be talking about rural areas here?

Mrs GALLUS—No. I come from a very urban electorate.

Mr Macfarlane—And people haven't got a bank to go to. Or they go to the bank and don't like it?

Mrs GALLUS—No; they have been placed in a great deal of uncertainty now as their branches disappear. There is a whole new system now where they are told to do their banking by phone. They do not have anybody to liaise with about what they read in the newspapers. We are now going to tell them that once they thought their deposits were secure in the banks, but maybe they are not as secure as they thought they were. There is a whole change out there that I think a lot of people—not the people you mix with—are just not going to be able to keep pace with. What sort of responsibility do we owe them to make sure that they can keep up with the system as it changes?

Mr Macfarlane—I don't know how we are going to tackle that. I agree with you on telephone banking: I can understand why people don't like telephone banking—but fortunately at the moment that is not the only alternative. Most payments that you have to make, there are the usual worries: there are too many alternative ways of making it. But usually you can write a cheque, put it in an envelope and send it off the way you always did. I think the bigger problem is where there has been a branch closure. As I say, I think the hope of the side there may be that the credit union movement, which is much more people based probably because they are on a smaller scale, might step in.

CHAIR—Mr Macfarlane, I am going to ask you one more question on the Wallis inquiry and a couple of colleagues would like to ask you some general questions. So if we could just come back to this Wallis issue. The Wallis committee goes into great detail on financial efficiency and how our financial services could be made more cost effective. It does not say a lot—it says a bit—about how you protect the sovereignty of the nation. With the move to globalisation there is a very real risk, I would have thought, that we could find ourselves more and more controlled from outside the nation than within. At what stage should one be concerned about this?

Mr Macfarlane—That is a responsibility for government. It is not really, I don't think, an intrinsic aspect of financial market regulation. But it is legitimate for the community to say—for example, I have heard a number of people say—'We wouldn't want to become like New Zealand.' New Zealand does not have a domestic banking system; it is all owned by Australia and one bank is owned in England. I have heard people say that that is the sort of thing you have got to be aware of. That is an entirely legitimate area for government to make a decision. I, myself, wouldn't be very happy to have a banking system where every bank was owned overseas. If the community makes that decision, there are channels—in Australia's case, I presume, it is referred to the Foreign Investment Review Board—where the community and the government can make their views known.

CHAIR—I suppose this is an allied question to that: if there is increasing globalisation, are you aware of any impact this could have on the security of revenue for governments?

Mr Macfarlane—I don't know the answer to that. I am not a tax expert. But I am absolutely sure there are people who are tax experts who are thinking very seriously about that.

CHAIR—Would you feel concerned about it?

Mr Macfarlane—I think I would, yes.

Dr NELSON—I wanted to come back to the sluggishness in the manufacturing sector and just how seriously you view it. On the question asked by the chairman, I presume you are aware of the electronic commerce task force report that was released in March on the impact that technology is having on the revenue base, which I think would be of some concern to the bank. On page l, you say of the manufacturing sector, 'Conditions in the manufacturing sector have been an exception to this generally firmer picture that, profitability under pressure and investment intentions declining, the pressure on profitability reflects a combination of rising wage costs and flat selling prices, which continue to be constrained in many parts of the manufacturing sector by strong international competition.'

How do you see the manufacturing sector breaking from this cycle? You referred earlier in terms of unemployment and employment growth to institutional factors other than monetary policy. The people remaining in the manufacturing sector in Australia in this environment, which is reflected in the semi-annual statement, say that the nature of Australia's current taxation system and the impact of trade protection policies are having a significant impact on their economic prosperity, particularly wholesale sales tax and, to a lesser extent, payroll taxes. Does the Reserve Bank have a view? Would it be offering advice to the government on changes in, as you would say, institutional issues, which might improve the outlook for the manufacturing sector? In the absence of any change in taxation or trade protection policies, where is the manufacturing sector likely to end? It is unlikely, I would think, that wages growth is going to be that much more constrained in the medium term and I suppose that international competition is not likely to diminish.

Mr Macfarlane—It sounds a very pessimistic view. The fact of the matter is—the things you mentioned have all got some substance in them—that manufacturing has probably got more resilience than we give it credit for. It has had a lot of problems to face over the years. We had a cosseted, very highly protected manufacturing sector and manufacturing protection has been reduced substantially. At the time we were told that a lot of people, all the pessimists, said, 'There will be nothing left. We really can't compete internationally.' We have drawn attention to the fact that we think industrial relations in the manufacturing sector—wage outcomes—are detrimental to the future of manufacturing. How are they going to survive that? I don't know. How did they survive the reductions of tariffs? I presume they find ways all the time of getting smarter, moving into new areas and getting out of the ones that are unprofitable. A lot of international outsourcing goes on. You build this component here, you build the other component somewhere else and you put it together here. I don't really know the answer.

I have heard so many gloomy prognostications about manufacturing, and I have probably made a few myself, and yet the best manufacturers, the best management, do manage to get on with it. They have a lot of obstacles that they have to overcome. You mentioned taxation. There is a whole lot of other things. Parts of our transportation sector leave a lot to be desired. There is industrial relations. Somehow or other they soldier on and the best ones still thrive. I think they will adjust to the particular problem we are talking about. In answer to Ralph Willis, I think that they will adjust, the best ones will become good at doing the sorts of flexible wage deals they need to do and they will thrive, but there is a lot of other things that could be done to help them. But the ones in the taxation area I do not really want to comment on.

Mr WILLIS—If I could just observe on that point, I would have thought that the 20 per cent appreciation in the dollar in the last couple of years would have had some impact on the position of manufacturing industry at the present time in both limiting their export capacity and increasing import competition.

But the question has nothing to do with that. You would be aware of the Boskin committee report in the United States which found that the consumer price index in that country was overstated by about 1.1 per cent per annum, which in the context of roughly three per cent is a fairly large overstatement of the real inflation rate. You made some comments which seemed to indicate you thought this also applied in this country. Could you elaborate on that? To what extent do you think our true inflation rate is overstated by the consumer price index and, of course, also by the underlying price index which relies on the figures derived from the CPI? And what implications, if any, do you think that that overstatement of the true inflation rate has or should have for monetary policy?

Mr Macfarlane—The Boskin committee's finding of over one per cent is a very high one by the standards of other countries that have looked at it. I think there is a general belief that in the US the overstatement is higher than it is in some other countries. They change their basket less often than we do. The ABS at the moment is actually looking at the subject, and there are a couple of reports. They are looking at having an in-depth look at the CPI. They are looking at the other issue of whether mortgage interest rates should be in there, but they are also looking at these possible distortions—which are true in any statistical series. It is not as though the statisticians are incompetent; it is just that some of these things are extremely difficult to measure, particularly quality improvements.

I will reserve judgment on how big an effect it has on our's until I see what the ABS has said, but I think that figure of 1.1 is actually quite controversial in the US. Some people say that he has got it wrong, that he has overstated the understatement or he has understated it or something. Other countries have looked at it and seen figures of a quarter of a per cent. It seems to me there has to be some overstatement, because even the best statistician cannot correctly measure quality improvement. There are two or three other biases that are just impossible to measure. So I think there is a little tiny bit of overstatement there probably. But I doubt whether it has got a lot of implications for monetary policy.

In the US they think the big implication is for fiscal policy, because they have indexed all their payments, and the argument of the US is that we are overcompensating for people and we really should have a smaller CPI and we will not have to put up all our government payments so much each year. Our failure to measure the CPI correctly is causing havoc with our budget deficit, but my guess is the magnitudes involved here are probably a fair bit smaller. That figure of 1.1 is a bit of an outlier.

CHAIR—I am sure the Treasurer would like to discuss that matter with you further. Unless the committee has any further questions, I think we have had a very good innings. Can I on behalf of the committee thank you, Mr Macfarlane and Mr Thompson and Mr Stevens, very much for coming along today. I think it has been very helpful.

Resolution (on motion by Mr Anthony, seconded by Mr Albanese):

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 1.40 p.m.