HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

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

CANBERRA

Thursday, 12 September 1996

OFFICIAL HANSARD REPORT

CANBERRA

HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

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

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 annual report 1995-96

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Thursday, 12 September 1996

Present

Mr Hawker (Chair)

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

The committee met at 10.30 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this review by the House of Representatives Standing Committee on Financial Institutions and Public Administration of matters arising from the Reserve Bank of Australia's 1995-96 annual report. I would like to take the opportunity, first of all, to welcome representatives from the Reserve Bank, particularly Mr Bernie Fraser who is making his final appearance before this committee. I would also like to welcome Mr Ian Macfarlane as the incoming Governor, and Mr Les Austin.

The committee has been conducting reviews of the Reserve Bank's annual report for four years now and the governor has been a great supporter of this process. That support is very much appreciated by this committee and its predecessors as it has assisted the committee to develop a new and important role in parliamentary scrutiny. The evolution of this process into one which is beginning to provide an effective accountability mechanism is one which could well be emulated by other committees in this place.

The Reserve Bank plays a crucial role in the economic life of this country, having primary responsibility for monetary policy and the supervision of the banking system. The bank has become far more open in recent years and, with the new arrangement between the Treasurer and the governor designate, that process of opening up and accountability is set to continue.

The government has initiated a review of the financial system which may have a dramatic impact on the financial landscape. What this holds for banking, the broader financial services industry and the future role of this committee remains to be seen. However, I do expect that a number of Wallis inquiry issues will be raised today.

As has happened at recent hearings, the committee will continue its focus on monetary policy. This process has contributed to the increasing openness of the Reserve Bank on monetary policy issues, and the annual report does indeed endorse the benefits of that increased openness.

There are a number of issues that we hope to cover today, including inflation targeting, the bank's charter, the bank's record in forecasting, whether the Reserve Bank should make forecasts in the future, and the relationship between monetary policy and fiscal policy. I also expect that members will wish to cover a number of supervisory issues such as bank profitability, smart card technology, the current situation regarding guidelines for market risk and the role of the Council of Financial Supervisors.

Finally, I would like to draw attention to the fact that, in the 38th parliament, this committee has a new name and a new membership—with the exception of the member for Werriwa (Mr Latham) who was a member of the committee in the last parliament. While it is a new committee I wish to stress that we will continue to examine banking matters along with issues in the broader financial services. As we do have a large number of matters to raise with representatives of the bank I will not delay proceedings any further.

AUSTIN, Mr Leslie John, Assistant Governor—Financial Institutions, Reserve Bank of Australia, 65 Martin Place, Sydney, New South Wales

FRASER, Mr Bernard William, Governor, Reserve Bank of Australia, Martin Place, Sydney, New South Wales

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

CHAIR—Welcome. The evidence 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. Would you like to make an opening statement?

Mr Fraser—Thank you, Chairman. I do, as I have been requested to, have an opening statement. This is the fifth time that we have appeared before a committee like this but, as you have just noted, it is rather a new committee—a new name, a new chairman and mostly new members. I would like to begin, therefore, by reiterating that we welcome these meetings with the committee and, as in the past, we will do what we can to make them as informative and constructive as possible.

Despite occasional assertions to the contrary, the Reserve Bank is, and has been, a very independent central bank. And we take very seriously the responsibilities that go with that independence, including the responsibility to explain carefully to the public, to the parliament and to others what we are doing and why we are doing things. In other words, in the jargon, to be transparent and accountable.

One—but by no means the only—vehicle for this purpose is the bank's annual report, the latest version of which is the focus of our meeting today. The content of this document has increased by about 50 per cent over the past seven years. In that time also there has been a substantial increase in the flow of information from the bank, in articles in the bank's monthly bulletin, in speeches by senior offices of the bank and in other ways. Any serious student of the Reserve Bank and of its operations therefore has access to a good deal more information today than ever before.

I mention these developments because, with so much information now in the public arena, it is hard to say much that is new in an opening statement like this or to anticipate the angles which might be of particular interest to members of the committee. I will therefore confine my opening remarks to a few of the general matters which are covered in the annual report and, with my colleagues, will endeavour to answer your particular questions.

First of all, a word on the economy and monetary policy. As usual, performance across different sectors of the economy is varied, but overall the economy continues to grow at a relatively robust rate with low inflation. Total GDP grew by four per cent over the course of 1995-96 and non-farm GDP grew by 3.75 per cent. We have now had five years of non-inflationary growth since the recovery commenced in mid-1991, with GDP averaging a little over 3½ per cent a year and inflation averaging 2½ per cent a year. This combination of strong growth and low inflation puts Australia among the very top performers among OECD countries over this period.

The budget forecasts for 1996-97 envisage a sixth year of growth of around 3½ per cent with inflation of about 2.75 per cent. We agree generally with these forecasts but we think inflation through the course 1996-97 could be a little bit lower than the budget forecast. The growth forecasts are underpinned by a reasonably encouraging outlook for growth in our major trading partners, by good levels of business and consumer confidence and by the absence of any major imbalances in the domestic economy. The further large rise that is expected in business investment, which is forecast to rise 14 per cent in real terms in the current year, is an important key to achieving this growth forecast. Consumer and government spending are both forecast to grow by about three per cent.

At 3.1 per cent, underlying inflation in the year to the June quarter was a little above the two to three per cent average the bank is aiming for over the course of the business cycle. But we are as confident as we can ever be in economic forecasting that, when the figure for the year to the September quarter is released next month, it will be comfortably within the two to three per cent inflation target band and that it will remain there over the year ahead. The headline rate of inflation is likely to come back even more sharply. Hopefully, this new environment of relative price stability will be increasingly reflected in new wage bargains.

The inflation target, and the way it is expressed, is helpful to the bank in pursuing its monetary policy objectives. I think it is also helpful in bringing an element of predictability to the pervasive uncertainty that is always present in the economy at large and in the financial markets in particular.

The bank does not have an explicit target for employment or unemployment but we do pay particular attention to trends in these areas. We do so because our charter requires us to but, more importantly, we do it because it is sensible to do so.

The best contribution the bank can make to reducing unemployment is to help to sustain a good rate of economic growth. This involves the bank in making judgments about future developments in the economy and adjusting monetary policy in a forward looking or pre-emptive way and doing that in both directions. There were elements of this in the 15 rate reductions that were made between January 1990 and July 1993, and those rate reductions contributed to the economic recovery that I have already touched upon. There were elements of this same pre-emptive approach in the three rate increases that were made in the second half of 1994, and those adjustments helped to return growth to a sustainable rate when it threatened to accelerate too rapidly.

Unemployment declined from a peak of over 11 per cent at the end of 1992, to 8½ per cent in the middle of 1995. It has been stuck around that level over the past year. This stalling in the unemployment rate, together with the expected fall in inflation, prompted the bank to reduce the overnight cash rate—this is the interest rate which the Reserve Bank controls by half a percentage point at the end of July. The full effects of the flow-ons of that rate reduction to the interest rates charged by banks and other financial institutions have still to show up in the economic indicators.

Despite the relatively strong growth forecast for 1996 and 1997, the unemployment rate is forecast to decline only marginally over the year ahead, and to remain at about 8¼ per cent in mid-1997. While the budget forecasts can be viewed as mid-points in a range of probably outcomes, they are, of course, subject to significant margins of error in both directions. The Reserve Bank is alert to these risks and will be monitoring developments closely. As always, it will pay particular attention to the indicators which bear upon trends in inflation, employment and unemployment.

I would like to say just a few words about financial market developments. As you know, financial markets continue to be influenced by both international and domestic developments. The increasing globalisation of financial markets means that movements in bond yields and share prices in Australia tend to show a strong correlation with overseas movements, especially US movements. These closer linkages between capital markets are supplementing the traditional role that is being played by the exchange rate in transmitting international influences to Australia. Such international linkages do not diminish the bank's control over monetary policy—that continues to be determined primarily by developments in the domestic economy—but policy makers obviously need to be mindful of these international linkages.

The improvement in Australia's inflation performance and prospects over recent years, has seen a marked narrowing of the differentials between Australian and overseas long-term interest rates. These are the interest rates which are determined primarily in the marketplace and not by the Reserve Bank. The differential between yields on Australian and US ten-year bonds, for example, has narrowed from 300 points five years ago, to 250 points one year ago, to about 120 points today. New Zealand, which has had significantly higher short-term interest rates than Australia over the past four years, also has higher long-term rates than Australia at the present time; this is a fairly recent development. This reduction in the inflation premium that is built into interest rates in Australia, is of obvious benefit to both private and government borrowers.

The exchange rate of the Australian dollar has rebounded from the unusually low levels of a year ago, mainly in response to improved prospects for the world economy and for commodity prices. In trade weighted index terms, the rise in the Australian dollar over the past year was about 9 per cent. I think that a more relevant comparison is with the average level of the past ten years when the trade weighted index has fluctuated around a flat trend. On that basis, the trade weighted index today is about 4 per cent higher than the average level for the past 10 years.

Given that movements in the exchange rate have been well based—that is, they have tended to reflect fundamental rather than speculative factors—the Reserve Bank has not been intervening in the market to try to influence the exchange rate. But, as you would have noted from the annual report, the bank has made substantial purchases of foreign exchange during the past year, both to cover the government needs for foreign exchange and on its own account to facilitate a further runoff of the outstanding swaps that were accumulated during 1992 and 1993 when the bank was intervening heavily to support the Australian dollar. At the margin, these foreign exchange purchases have probably held back a little the appreciation of the Australian dollar over the past six to twelve months.

If I could move on now to say just a word about banking and the financial system and the supervision thereof. The past year has seen increased competition in banking, not only in wholesale banking which has always been very competitive, but also in the retail market. Largely because of the increased competition from mortgage originators, mortgage interest rates have fallen even though official rates have remained unchanged—and they have fallen for all borrowers, not just the new home borrowers. This competition in housing, in particular, can be expected to hasten the decline in banks' interest margins but we will have to wait for more data before we can see this. This is because the latest available data relate to the six months to the March quarter of 1996 and only a marginal fall in interest margins is evident in that data.

In the meanwhile, most banks have continued to report good profits in 1995-96 and other measures also indicate that the industry overall is quite healthy, with bad loans equivalent to only one per cent of total assets, compared with the peak of six per cent in early 1992. The average capital ratio for all banks in Australia is currently a little over 11 per cent and that is comfortably above the minimum BIS requirement of eight per cent.

Bank supervision is an evolutionary business and a number of further changes were made during the past year in response to changing conditions and experiences. These changes are documented in the annual report and include arrangements for incorporating market risks as well as credit risks within the capital adequacy requirements; revised guidelines on the involvement of banks in funds management and securitisation activities; new arrangements for external auditors of the banks; and the liberalisation of guidelines to permit banks to make some equity investments.

The latest annual report also includes a special chapter on longer term developments in the financial system. This contains some useful background information for people interested in the subject matter of the Wallis inquiry. This committee has a copy of the bank's submission to the Wallis inquiry and we can speak to the detail of that later if you wish. But for the moment I would like to make just two general comments. The first one is that I think it is a very tall order to expect the inquiry to come to grips with the complexities of the Australian financial system and then to advance recommendations for sensible improvements in the short time available to it. Its task is not made any easier by the promotion of some quite radical proposals from certain stables without much evident analysis of the perceived shortcomings of the present arrangements or of the ramifications of the proposed new arrangements.

The temptation to latch on to an overseas model of one sort or another and seek to transport it here, without fully appreciating how it operates in its home environment, let alone in a foreign environment, quite frankly is rather scary.

The second general point I would make is that we accept, of course, that there is always scope to improve present arrangements, whatever we are talking about. We have made some suggestions in our submission for improving supervisory arrangements relating to banking and the financial system. It is our belief, however, that guided evolutionary change is the way to go and that to adopt radical proposals such as a mega-regulator or, at the other end of the spectrum, to rely entirely on disclosure, would really be flirting with disaster.

Finally, just a word on the bank's own operations and the latest annual report includes, once again, considerable information on the bank's own operations during the past year. I will not go into any detail here, but I think three points are worth mentioning. First, the bank's net operating earnings for the year totalled almost $2.5 billion and this compares with an average of $2.1 billion a year over the past decade. Most of these earnings, of course, flow straight into the budget revenue.

Secondly, staff numbers in the bank declined marginally last year, after having fallen by one-half during the preceding decade. Thirdly, the bank's operating costs declined further last year. In real terms, these costs are now about 20 per cent below their peak in 1991-92. Mr Chairman, I think that is more than enough to get the ball rolling, so I will end there.

CHAIR—Thank you, Mr Fraser. First, I trust that the outcome of the Wallis committee inquiry will give you a pleasant surprise. Can I start by looking at the question of national savings? On page 15 of the annual report, you say that one of most effective ways of addressing the current account problems is to improve national savings by 'moving the budget into surplus'. Would the bank, therefore, approve of the way that the current budget has been presented to the parliament?

Mr Fraser—We approve of the progress towards reducing the budget deficit. That is something that we have been sniping at all governments about from the sidelines for some years, because we do believe that we have a national savings problem and that one of the major ways of remedying that is to reduce the government sector's demands on national savings by moving out of deficit into balance and, hopefully, into surplus. So, in terms of the aggregate movement, we certainly support the reduction in the budget deficit.

I have also over the years made comments about the importance of the way budget deficits are reduced and the fairness of the methods that go into reducing the budget deficit. These are quite important issues. As a central banker, I can only make reference to the issue, as it is really a matter that has to be resolved at the political level; but fairness is important in fiscal and monetary policy matters. For that reason I make no comment on the fairness or otherwise of the measures that have been employed in reducing the budget deficit, but the actual reduction is something that we need.

CHAIR—In your opening remarks, you talked about the level of unemployment, the reduction that has occurred, and the expectation in the coming year. One of the questions that occurs to me is this: in the latest environment, what level of unemployment would the bank see as being achievable? In other words, what would you see as a realistic objective for reducing unemployment?

Mr Fraser—I do not think anyone knows the answer to that question. There is no precision in these kinds of things. What we can all be confident about is that it is a good deal lower than 8½ per cent, and it is a matter of continuing to do things—and those things go well beyond monetary policy—and working in ways that will reduce the level of unemployment. When you get to the point where there are problems—be they inflationary problems or current account problems—that start to emerge, you will start to know. Only then, I suggest, will you know what the non-inflationary rate of unemployment is. But, as I say, it is a good deal lower than where we are at present.

CHAIR—I think we would all agree with that sentiment, but could you give us some sort of figure that you think would be realistic?

Mr Fraser—You can ask a lot of people and you will get a lot of different answers. I do not see any reason why we could not be aiming to get down to five or six per cent and then see what happens when we get there, if we get there. But, as I say, there are issues involved here that go way beyond monetary policy.

CHAIR—You talk also, on this question of unemployment, about the relative price stability being reflected in new wage bargains and so on. Does the bank view with some concern the demands that are coming currently from the ACTU for a 30 per cent rise over the next three years?

Mr Fraser—Central bankers always worry about wage increases, but the fact that we lowered interest rates a short time ago and the fact that we are talking about the inflation rate coming comfortably back within our two to three per cent indicates that at least for the time being we think that wage increases are under control. So at this point in time we are not worried about any particular claim as such. It is the outcomes that are going to be important. We have expressed a number of views about the general orders of magnitude of wage increases that are consistent with keeping inflation within in that two to three per cent band. That is a four to five per cent wage increase on average across the whole economy.

The kind of system we have for determining wages these days means that there will be considerable disparity about that average increase. It is a bit hard to make pronouncements about any particular claim without knowing what the outcome is likely to be, what kind of productivity offsets there are going to be or whatever.

CHAIR—On this issue in the annual report you did make the observation that one of the significant factors has been the fact that real wages grew faster than improvements in productivity. Does this mean that you therefore believe that the process of micro-economic reform ought to be reinvigorated?

Mr Fraser—There is always a lot to be done on the micro-economic reform front. Modern economies are like Alice in wonderland—you have to keep running faster and faster to stay still. Micro-economic reform is one of those areas where that is true, but a lot of things have happened and a lot of things are still happening. They are mostly for the good and that is reflected in the kinds of improvements that we are seeing in productivity.

It is hard to interpret some of these numbers, but it is clear that there has been quite a lift in productivity in the 1990s. Some numbers that are familiar to me are that in the non-farm market sector of the economy productivity has averaged about 2¾ per cent a year in the 1990s compared with something like two per cent in the 1980s. I think that the micro-economic reform that has been going on has been substantial and it is—as one would hope—showing up in increased productivity where one would expect it to show up.

CHAIR—I would love to hear you continue, but I do recognise we have other members of the committee. Would someone else like to follow up?

Mr WILLIS—Can I ask you about the interest rate cut of half a percentage point at the end of July? You said that the cut was made then because benefits of a little insurance against the economy faltering outweighed any risk that inflation might kick up unexpectedly. What factors were causing the bank to consider the economy could falter?

Mr Fraser—There are always risks that the world economy might slow down, the recovery in Japan might not get under way, the recovery in Germany might falter, the US might bring their strong growth to a halt and the Asian economies are slowing down. So there are those kinds of risks that are always present.

There are also the same risks the other way, that the US can go on too strong.

It was more the fact that there had been no improvement in the level of unemployment over the last 12 months. There had been very little change in employment as such over the first half of 1996 and, while the outlook pointed to some recovery after the sluggishness in the economy in the June quarter, the fact that inflation seemed to be fairly clearly set to come back within the two to three, indicated that there were minimal risks in trying to encourage a bit more activity and provide a bit of insurance that the growth rate would be maintained, because maintaining growth is the best way to sustain employment and thereby reduce unemployment. So it was that kind of thinking really that prompted that reduction.

Mr WILLIS—If I can ask you a question about the statement on monetary policy that was agreed by the Treasurer and your successor. What difference, if any, do you think that will make to the conduct of monetary policy and, in particular, are you concerned that it moves the emphasis more towards inflation control and less towards the full employment objective than has been the case in the past?

Mr Fraser—I will ask Ian, who was a party to that agreement, to answer that. My comments really do not matter much now, although I have said publicly that, because the agreement basically formalises what is in the Reserve Bank Act, to that extent, I would be comfortable with it. Because it repeats what is in the act, I do not myself see the need for it. If it were to put inflation control more to centre stage, I would be concerned. But it is not my issue, and Mr Macfarlane is the one who was a party to it.

Mr Macfarlane—The main purpose of the statement on the conduct of monetary policy was really to formalise a situation that already existed. The first part of it was just to let the community, and particularly the community overseas, know that the Reserve Bank Act always has given—and still does—the Reserve Bank responsibility for monetary policy. Gradually, the domestic community has woken up that that is the situation. I think you helped it a little bit, in the last year of the previous government, when you made some statements that indicated that. I thought they were a long time in coming but, when they did come, I was very pleased to see them.

The other thing which you also did, but which did not attract as much attention at the time as I would have liked, was to endorse the inflation target. What this document does is—rather than just mentioning these things in the course of another general speech on the economy—set up a document that we can refer back to—particularly when overseas—where the government and the central bank are both stating that that is the basis on which monetary policy is conducted.

I think we have paid a penalty over the years in the fact there was a lot of misunderstanding, particularly overseas and amongst international investors who were very suspicious about the way monetary was conducted and who often made quite scurrilous interpretations of changes in monetary policy. One of the reasons for that was that even though we, as the central bank, explained our point of view and said, ‘No, we are running a system which is based on central bank independence and an inflation target’, the scepticism was there because there was no high profile statement by the government that that was also their point of view. This document, really, was designed to give a high profile to the government’s endorsement of a model which I am sure you are comfortable with.

Mr WILLIS—Some people have interpreted this as moving, as the Governor said, the inflation objective more to centre stage and becoming the prime target. Do you see it as having any such implication?

Mr Macfarlane—No, I do not see it as being a change in that sense. If you wanted to make that claim, you would have made that claim—and I do not think it is a very strong claim—at the time the Reserve Bank introduced an inflation target itself, which was in a series of steps, during 1993.

It then gained more public acceptance as the next couple of years went by. If you wanted to make that claim, you would say that the moment we put a number on inflation and said, 'This is what we want to achieve in the medium term', we were, in a sense, giving inflation a different treatment from what we were giving to unemployment because we do not put a number on unemployment, we put a number on inflation. That is just the recognition, and it is a recognition which has occurred in all countries that, in the long run, monetary policy can actually achieve something on inflation. But, in the very long run, it cannot make the economy grow faster and achieve lower unemployment.

Having said that, I want to qualify it by saying that, certainly in the short run, monetary policy, if handled clumsily, can have very bad effects on output and employment. And that is one of the reasons behind the more flexible nature of our inflation target. If you had a very doctrinaire, inflexible attitude to an inflation target, you could create a lot of unnecessary suffering in the short run. So we have an inflation target which gives us the scope to avoid that. At the same time, we recognise that, over the space of five or 10 years, or any period which you could define as long run, the major lasting contribution that we could make is to maintain Australia as a low-inflation economy.

Mr WILLIS—On that point, you do not think that the statement in any way changes the Reserve Bank's interpretation of its role under the act?

Mr Macfarlane—No, I don't.

Mr LATHAM—Mr Macfarlane, how do you reconcile that with your statement on 2 March when you spoke to the MTIA? You said:

Even if preventative action causes the economy to slow appreciably and results in unemployment edging up for a while, it would be a small price to pay.

Mr Macfarlane—What I was saying there is that in the long run, if you want to have a good performance on growth and a good performance on employment, the best thing you can do is to pursue policies that extend the length of the recovery. In the past, we have sometimes had the problem—and not just in Australia but in most OECD countries—of very strong expansions and a build-up of very big inflationary pressures followed by sharp contractions. In the sharp contraction, unemployment goes up very sharply. The way that monetary policy can contribute to a better outcome is not to have a

short sharp expansion which generates inflationary pressures, but to have a long slow one. To have a long slow one, it means that you occasionally have to be pre-emptive, as Bernie said, and at the first signs of things getting out of control, you have to squeeze down. Sometimes, the squeezing down will, in the short run, give you a worse result on employment than if you had just gone for rapid growth in the short run.

We look on the tightening of monetary policy that occurred in 1994 as being a very good example of pre-emptive monetary policy, and we think that is going to lengthen the upswing or the expansionary phase. There was a cost and the cost was that unemployment, for the time being, has flattened off at 8½ per cent. We think that is a cost that is worth paying in order to increase the possibility that, instead of just having five or six years of expansion followed by a recession, we have an expansion which is a good deal longer than that. That will be much better in the long run for growth and employment.

Mr LATHAM—On that question of pre-emptive movements, in your exchange of letters with the Treasurer, did you also suggest to him that it might be useful for the Treasurer to exchange letters with the trade union movement to gain their commitment to the bank's underlying inflation target, given that, without such a commitment, the bank effectively loses its security blanket on wages policy and would have to be more pre-emptive in its adjustments of monetary policy?

Mr Macfarlane—I have not spoken to the Treasurer about correspondence with the trade union movement. No, I have not spoken about that.

Mr LATHAM—Do you think it would be a good idea?

CHAIR—Can we try and share the questions around a bit?

Mr LATHAM—Well, this is my last one for the moment. Do you think that is a good idea? That is, do you endorse the sorts of comments that have been made from the bank in the past about the usefulness of an accord process?

Mr Macfarlane—I certainly believe that in an environment where the central bank and the government have the aim of monetary policy and other policies being to maintain inflation, on average, at something between two and three per cent—in other words, that two point something per cent is the average over the long term—then it would be extremely unfortunate if the trade union movement were to aim for an average increase in wage settlements that was not consistent with that.

I do not think they will. I think in some particular industries it is happening. But we do not think they will, on average. As Bernie has already said, as long ago as nearly a year ago—or certainly in the early part of this year—we have said what we think, on average, a wage outcome consistent with two to three per cent would be. But it is very

difficult to specify individual settlements because we do have a much more decentralised wage fixing system.

We were actually moving a long way in that direction under the previous government and it is going to continue under this government. So it makes it very difficult to come up with an average that everyone has to finally average out at. I am sure the ACTU is in that position, where they cannot actually specify to each member union or each person who is engaged in enterprise bargaining, 'You are not allowed to have five, you have got to have 4½,' or, 'You're not allowed to have six, you have got to have 5½ because the average has got to come in at 4½.' It is very difficult to conceive of the ACTU being able to police an average outcome in a decentralised environment. We are doing what we can do—

Mr LATHAM—I would like to come back to that. But I will let others—

CHAIR—Mrs Gallus has a question.

Mrs GALLUS—Mr Fraser, you talked about making monetary policy in a pre-emptive way. What do you see as the lag time between raising or lowering the interest rate and the maximum effect that you are going to achieve? I understand it would probably be normal distribution, but at what time do you get the maximum effect?

Mr Fraser—Again, no-one knows and it depends on what else is happening in the economy. There are effects that start from the time the actual change is announced. There are announcement effects that impact on sentiment and on confidence, and they start to work immediately. But in other cases, if interest rates come down, for example, it takes time for that to be reflected in consumers' decisions to borrow more to build a house or to get a car or replace a car.

It takes even longer for businessmen and women to decide whether the lower interest rate environment is going to affect their investment decisions, and those decisions have to pass through boards and then have to be implemented in spending decisions and actually hiring people, and so on. So there is a whole array of effects that start from the time the change is announced that run through perhaps for 12 to 18 months. How quickly they run through depends on what else is happening in the economy, I think.

Mrs GALLUS—So when you are making the pre-emptive move you are looking forward, for about 12 months down the track, to calculate the effects that that move is going to have?

Mr Fraser—You are looking forward to how you think the economy is likely to be developing over the year ahead and what might be happening to employment and unemployment, what is likely to be happening to wages and prices and therefore what is going to be happening to inflation. They are the two main things that we have in mind. So we are looking ahead, making judgments as to what we think might happen, and adjusting monetary policy in the light of those.

Mrs GALLUS—One final question on that. The changes in fiscal policy by the government obviously have the potential to interfere with what you are trying to achieve. Is the relationship such with the government that you can avoid those sorts of clashes?

Mr Fraser—There is not necessarily a clash. In economics, everything is connected with everything else. Monetary policy works on activity; fiscal policy works on activity; but one of the difficulties with fiscal policy these days is that, while it has an effect on activity, you cannot be sure what the direction of that effect is. With monetary policy, if you put interest rates up, you can expect that to have a negative effect on spending, investment and activity. If the budget deficit is cut back substantially, that will certainly have a negative effect on government spending and on those components of the community that are dependent upon that spending; but those negative effects might well be offset by what are seen as positive effects in other parts of the private economy that can actually offset the negative contractionary effects of some cutbacks in government spending.

It is very hard to be confident about what the net macro-economic impact of any particular budget is. It will depend upon confidence in the private sector and on all the other things that are going on at the time. When we made our decision at the end of July to change rates, we did so on the basis of our assessment of what was happening to employment, unemployment and inflation, and of what was likely to be happening in those areas over the period ahead. Obviously, we factored in a view about what we thought might come out in the budget and about what the effect might be, but it was not a major influence in that process.

CHAIR—Mr Fraser, in light of that answer, what is the bank's best estimate of the boost to investment, output and employment, from that relaxation in July of monetary policy?

Mr Fraser—We are only talking about one-half of one percentage point. You cannot disentangle the effect of that kind of interest rate reduction—or any other interest rate change—from all the other things that are going on in the economy, such as budget policy, overseas developments, commodity prices and the exchange rate. I do not believe you can in any sort of precise, quantitative way make an estimate of the effect of such a modest change in interest rates on things.

CHAIR—I have got colleagues everywhere wanting questions, so we had better try and keep it moving.

Mr CAUSLEY—Mr Fraser, in your opening remark, you touched on your role in monitoring and defending, I suppose, the Australian dollar. You would be well aware of the effects that that can have on our major export industries in farming and mining. I think we would also accept that the Australian economy is rather a minnow in the world sea. It is not possible, for strong economies who are our trading partners and who have a vested interest in getting raw materials at the right price, to manipulate the Australian dollar? What power do you have to overcome that?

Mr Fraser—Even though we are a small economy—a minnow, as you say, in the world sea—we do have a very large foreign exchange market. We are quite a deregulated foreign exchange market. The BIS, the Bank for International Settlement in Basel in Switzerland, does surveys of the size of foreign exchange markets around the world. Do not hold me to the precise rankings, but the Australian foreign exchange market is about the seventh or eighth largest foreign exchange market in terms of trading and turnover in the world, and the Australian dollar is similarly the seventh or eighth most traded currency in the world.

It is a big market. People cannot, I believe, manipulate the Australian dollar in a market with the kind of depth that is there. What could we do if they decided to take a set against the Australian dollar? It depends; and there have been occasions when, not for manipulative reasons but for good rational reasons, foreign investors have made judgments that it might be safer and make good sense to get out of the Australian dollar for a time, or to come into the Australian dollar at different times.

What do we do? If the exchange rate is going up, for example, because the world economy is looking stronger and commodity prices are rising—and that was seen to be good for Australian exports and for investment in Australian industries, and so on—and money is flowing in, they are good fundamental reasons. Or if we have a higher interest rate here and were attractive because of that interest rate differential to foreign investors, or if the current account deficits were coming down, they are other fundamental reasons. If there are capital inflows for those kinds of fundamental reasons, as distinct from what I call speculative reasons, there is no need for the Reserve Bank to do anything at all.

In 1992—and 1993 particularly—there was a lot of outflow and the dollar was under a lot of pressure. At that time, we judged that that was at least partly for speculative reasons, and partly for reasons that we thought were very short-term, and we thought that the Australian dollar had been pushed down too far. This was a concern because, if the dollar is depreciated too far, that has quite important implications for inflation. In 1992, and again in 1993, we thought that had happened and we intervened to try to prevent the fall going too far, further than we thought was appropriate. We had some success.

It is hard to measure the success. But, one measure of that performance is the profit that one makes on the intervention. On the whole—not on every transaction—the Reserve Bank has bought things when they were cheap and sold things when they were high. So it bought the Australian dollar when it was cheap, and sold it when it was high. It has made profits. That was not the objective, but I think that intervention has helped to take out some of the speculative troughs and peaks.

Mr HOCKEY—In your opening remarks, you referred to the narrowing of the differential between Australian and overseas long-term interest rates, and you specifically referred to the narrowing of the $A rate in the US 10-year bonds. Do you see that trend continuing? Is there a danger that that trend will not continue because of the wages push by the ACTU, as well as wages outcomes? For example, in New South Wales, about 70,000 teachers just settled on 16 per cent over three years, or a little less than three years, so some of the outcomes are actually exceeding expectations on wages.

Mr Fraser—The narrowing of these long-term bond differentials that we are talking about have occurred, basically, because we are getting some runs on the board on lower inflation and because investors are believing that the Reserve Bank is serious when it says that inflation will be held within the two to three per cent. So, whether it will continue will depend on what happens to our inflation rate, relative to what is happening elsewhere. And, as I have already said, at least for the next year or so, we expect inflation in this country to be coming down from where it is. In that sense, there is scope for those differentials on bond yields to narrow, perhaps, even further. But inflation, and all the factors that go into that, is the critical thing in this.

Mr HOCKEY—Given the importance of inflation, do you think that there is room for Australia to publish monthly inflation figures, as they do in the United States?

Mr Fraser—I think that would be a mistake. We are already inundated with too many numbers. Monthly current numbers are a particular problem area for me. Given that we have an inflation target, having monthly numbers—which, by their nature, will be jumping around a good deal—might excite a lot of attention among colleagues from the press here, but I do not know that it would do anything to improve the quality of decision making. That would be my view.

Mr McMULLAN—Following from the previous question about the change in the nature of wage setting arrangements in the country, and their implications for you and your responsibilities, you refer on page 12 of the annual report to the role of the Accord in redressing some of the imbalances that were in the early 1980s in the labour market. You say on page 25 that you have a concern about high settlements emerging in enterprise bargains. With the increasing emphasis on a deregulated labour market and the more opaque arrangements that are now emerging, does this directly give you cause for concern that some of that imbalance that was redressed might re-emerge? Does it give you any concern about the possibility of heightened uncertainty about wages outcomes that might feed into interest rate judgments or inflation judgments?

Mr Fraser—There are lots of questions there. It is no secret that I think the Accord was a very helpful instrument in correcting what was called an 'imbalance' that flowed over from the 1970s. This was an imbalance that came about because the wages share of national income rose quite dramatically in the 1970s and the profit share declined quite dramatically; and that had all sorts of implications for investment, employment and so on. A lot of the 1980s was taken up in correcting that imbalance, and the Accord process contributed to that.

Initially, the Accord process had a centralised system. One of the technical aspects of that centralised system was that it was easier to forecast what was going on in wages: it was less 'opaque', in your words. It was easier to get a handle on what was happening to wages and what might be happening; but, in more recent years, there has been a progression towards decentralised industry bargains. It has become rather harder to get a handle on what is happening to wages out there, but I think this is a monitoring problem, a technical problem, rather than a substantive one.

The critical thing remains: what is happening to the average level of wage increases across the whole economy? It is harder to look at what is happening to the one-third of the economy where enterprise bargains are operating, to the second one-third where there are award systems, and to the other one-third where there are basically contract kinds of systems with executives, and to put all those movements together and average them out in a reliable way, but that just makes decision making a bit more complicated. The basic requirement that average wage increases remain moderate has not changed. That is still the critical thing for inflation and basically for investment, employment and a lot of other things as well.

Mr McMULLAN—May I follow up on that briefly? Does that increase the uncertainty, and is there a premium on that? Does that have an impact? Do you regard average weekly ordinary-time earnings as the best measure, or is there some other measure to which you refer?

Mr Fraser—I am not sure I understand the first question.

Mr McMULLAN—I will not pursue it. I'll discuss it with you when we have got more time to qualify it and discuss it in detail.

Mr Fraser—We look at all the measures that are available of wages and prices—and everything else, for that matter. But in the wages area I think it is fair to say that in terms of getting a handle on what has actually happened to wages in the economy we do look at ordinary wages—the so-called AWOTE or ordinary time earnings for adults. They are the main measure of what is happening in the economy. As well, we look at this rather partial data that is available on enterprise bargains that are being negotiated—new enterprise bargains that are negotiated and the average wage increases in those—because they give you a bit of a forward look at what is going on. But they relate only to a small part of the work force so one has to be careful in interpreting those.

But, obviously, if the new enterprise bargains are turning out average increases that are going up and up all the time, either that trend will be reflected in other wage settlements and therefore push AWOTE up, or it will mean that other parts of the work force will be having to settle for much smaller increases if the average is to remain consistent with the inflation objective. Again, as in all these things, as with the question about interest rates earlier on, there is no precision or science. It is very much a matter of an art, I think, interpreting these things.

CHAIR—Okay. Mr Anthony, you have a question.

Mr ANTHONY—Firstly, I would like to officially wish you all the best in your future endeavours, Mr Fraser.

Mr Fraser—Thank you.

Mr ANTHONY—I also wish the low inflation environment will cause lower unemployment. My question is directed to the governor designate. It is many years since I can remember when we had international credit agencies re-rating Australia, which they did two months ago. Do you think too much emphasis was placed by previous government administrations on using the monetary policy lever, rather than fiscal policy? I ask that because, with the recent budget, there has been quite a significant mood change by our credit rating agencies and by our off shore financial investors. Do you see this as a result of a more appropriate fiscal policy?

Mr Macfarlane—I did not read the text of the S & P statement, but I think it was linked to fiscal policy. In relation to this business about whether you do too much on fiscal or too much on monetary policy, I think the big change that has occurred—and it has been occurring pretty continuously—is to take a medium term focus on both of them, and take fiscal policy to have some sort of view that, at a very minimum, in the long run the underlying budget deficit should be in balance. That may not be the perfect rule but it is not a bad rule.

What it means is that if you are well into the expansionary phase of the cycle you would be very disappointed if you still had big budget deficits. So fiscal policy is adjusted in terms of achieving this medium term result. Monetary policy, of course, has a much more medium term orientation too. And the medium term orientation is built around this idea of ending up—over a cycle, over a long period—with an inflation rate of two point something.

However, it still means that if you got an unexpected shock to the economy, in the sense that you suddenly discovered it was growing much faster than you thought or falling in a heap much faster than you thought, the implication would be that monetary policy would be the instrument that you would look for, rather than fiscal policy. It does not rule out fiscal policy. But I think people have much less faith in countercyclical fiscal policy than they had before. It does not rule it out, but they have much less faith in it. But the important thing is the medium term orientation of both.

CHAIR—I will take two more questions, from Mrs Bailey and Dr Nelson, and then we might have a coffee break as people are probably feeling like one.

Mrs BAILEY—Mr Fraser, do you think the level of risk premium that is being charged on small business today is impeding growth and employment?

Mr Fraser—That is a hard one. I think the way I would answer that is to say that small businesses, as I understand it, have lots of problems, but one problem they do not really have at the moment is getting access to finance. Maybe they pay a bit more than they would like to pay, but the banks are running a bit bigger risk in lending to them than they would if they were lending to other borrowers.

We have, as you probably know, a small business panel that is a kind of advisory body to the Reserve Bank. This is made up of 12 practising small business people. We meet with them from time to time to get advice as to what is happening in terms of their access to and the cost of finance from banks and other sources. We had a meeting with the panel only a few weeks ago, and I think it is fair to summarise and say that most businesses, once they get a foot on the ground and they get established, that is after they have got something to build on and they are not starting from scratch, once they get started they have no difficulty getting access to finance.

Some complain a little about the risk premium, but we hear less of that these days because I think there is more competition among the banks to go after the small business business now because of what is happening to housing and some of the lending to large businesses. If small business people are prepared to shop around, they can do better than they might sometimes think. We do hear that they are doing that, small business people are shopping around. They are still having to pay more for money than BHP does, but they have a bigger risk and they have a higher failure rate. In any system of properly measured and controlled risk, that will be the case, that there will be a higher interest rate to pay for higher risk. But getting access to funds does not seem to be a problem for them and therefore, if that is not a problem, it is not really holding back investment by small business.

CHAIR—We seem to have a slight interruption here. It could be a quorum being called in the House.

Short adjournment

CHAIR—Unfortunately, parliament is sitting. I think Dr Nelson was next on the list with a question.

Dr NELSON—Mr Fraser, in the introductory statement you said that the best contribution the bank can make to reducing unemployment is to do what it can to sustain a good rate of economic growth. I am a lay person and I feel that the accord with the previous government failed in the sense that in the first decade we averaged 3½ per cent growth and 160,000 jobs a year on average being created, but at the end of the first decade we had gone from 670,000 to 840,000 people unemployed. It seemed to me that the union movement had negotiated what it described as a social wage, and we paid a price for that in terms of continuing government deficit and also failure to address the problems with the taxation system.

I notice that in your Tokyo address on 5 September you said, in relation to the industrial relations reforms that this government is trying to introduce, and I quote:

To the extent that these amendments when implemented help to better align wage increases with productivity increases, they will improve the prospects for sustained growth and low inflation.

Inasmuch as suggesting that Mr Willis suggested in his question to Mr Macfarlane that we had moved from a full employment target to an inflation control objective. Perhaps the Accord process had failed. Do you feel from the comments that you made that the industrial relations changes that we are now trying to make are likely to contribute to growth and therein reduce unemployment?

Mr Fraser—No, I have already said quite a lot about the accord. I think the accord did contribute to wage restraint. You have only to look at the numbers to see that. I do not know how people can dispute that. We have had a long period of wage restraint; we have had a long period of declining industrial disputation. Again, if you look at that Tokyo speech you will see some numbers on how industrial disputation has come down.

We have had a lift in productivity in the 1990s compared with the 1980s. A lot of good things have happened and the Accord was not the only part of that, but the Accord contributed to wage restraint, the lower inflation and the things that flow on from that.

The industrial relations legislation—the bit that you referred to there—I think, as that quote said, to the extent that the changes do continue the process of relating wage increases to productivity increases, will enhance the prospects for growth and employment and so on. It will be a continuation of what has been going on.

If you read a little bit beyond that passage you have just quoted, you will see a reference to a view that I hold strongly, that it is not the industrial relations legislation that is going to be important in driving these necessary improvements in productivity. The important forces there are the ones that have been emerging over the last decade or longer. They are the competitive forces that come from the Australian economy now being more open and subject to more competition, both domestically and in export markets. They are the kinds of things that are going to continue to drive progress towards better working arrangements, better productivity and moderate wage increases. If we do not do those kinds of things, then in this new environment where there are global markets for everything, we are going to slip behind. I think Australians have woken up and are smart enough to see that.

It is these fundamental factors that are going to be the important things, rather than the changes in industrial relations legislation, as important as some of those changes might be for particular things. But in terms of driving the kinds of improvements in productivity and whatever, I think it is more those ongoing global competitive pressures that are going to do the trick.

CHAIR—Okay, Mr Mutch and Mr Pyne both have not had a question.

Mr MUTCH—I sympathise with Neville Wran for the first time. In our discussions with banking officers, there has been some strident criticism of what is seen to be the RBA’s commercial activities. They criticise areas such as government banking, banking for overseas agencies and securities clearing, registry and settlement services, saying they should not be carried out by the RBA. They say there is a conflict of interest and they should be put to tender. What are your thoughts on this and I would also like to refer that one to Mr Macfarlane, if possible?

Mr Macfarlane—This is being reviewed at the moment under the national competition policy, the task force there, in carrying out the Hilmer proposals. Our basic view on this is that, if we are doing it efficiently and if we are costing it properly, and our customers want us to do it, that is okay, because it is actually up to the customer. We do not have anyone locked in. We have not got any regulation that says someone has to use us. For example, for government banking, the Department of Finance chooses to use the Reserve Bank because they are happy with the service they get.

We think that the task force on competition policy, which is going to have a good look at what we do and how we cost it, is a very sensible move and, naturally, we will cooperate with it. We think we are in good shape and that we do actually price it correctly. So we are not using profits from other parts of our operation to cross-subsidise that. We are strong supporters of the competition policy task force and we will cooperate with it.

Mr Fraser—I add that we do believe in competition. I hope that, when push comes to shove, some of these characters who are saying that we should not be in it also believe in competition. I hope that we can have a fair crack at the business and it is not settled on a matter of ideology.

Mr PYNE—Mr Fraser, for some years, Australian governments, federal and state, have talked about a national consumer credit code and the federal government moved a few years to indicate that they would legislate unless the states did something about it. So the Queensland government passed legislation which was to be copied by all the states and in complementary legislation by the federal government. That was done in 1994. There are still two states that have failed to pass the complementary legislation. Which states are they? Why haven’t they? What continuing cost is that occurring in that industry?

Mr Fraser—I think things have perhaps moved on a little bit, but I have got just the man to answer that question.

Mr Austin—Well, things have moved on a little bit since we did the annual report. The two states involved were Western Australia and Tasmania. But I am informed that they have now, in fact, passed the legislation. So that the start date of 1 November for the uniform credit act will now apply in all states.

Mr PYNE—Did they pass them all without qualification: there were no ifs and buts or backsliding by Western Australia or Tasmania in anyway?

Mr Austin—In the case of Western Australia, they have adopted the stance that they would prefer to pass their own legislation, rather than just adopt the Queensland legislation.

Mr PYNE—Unlike the other states.

Mr Austin—Unlike the other states who just adopted the Queensland legislation. But I believe that there are not significant differences, not that I am aware of anyway, between what they have passed and the Queensland legislation. I think there is a wrinkle too, in the Tasmanian case, that some small credit providers have been given a little bit more time to come into line with the national requirements. They will come into line some time in 1997. The major operators can adopt the code from 1 November.

Mr PYNE—I just follow up on that question, do you have any idea what the cost has been so far to banks, credit unions and building societies of meeting this consumer credit code?

Mr Austin—I do not think we could accurately say what it has cost to the banks, but it is certainly a large amount. A lot of time has been put in by the banks and other financial institutions to meet the requirements. A lot of their computer effort has been devoted to that. I know that they feel that other projects that they wanted to get on with have been squeezed out because of the need to get the systems ready to meet the codes. The costs are both direct costs to the banks and also opportunity costs for them: they could have been doing other things with their resources. I do not think we have available a precise dollar figure that we could quote you.

Mr PYNE—Have you got some ballpark figure?

Mr Austin—No, I do not think I would like to give you a ballpark figure.

Mr LATHAM—I asked a question about the budget to Mr Fraser. I notice, with interest, references in the budget papers to recent reports by the IMF and the OECD noting that there are substantial substitution effects between public savings and private savings. What view has the bank got as to those substitution effects out of this budget, given that so many of the measures are a straight transfer from private savings to public savings and have no net improvement in national savings? In some of them, superannuation, for instance, it seems to be taking money from private savings and putting it towards fairly non-productive uses—salary packages, fringe benefits being changed and the like. I am interested in the assessment that the bank has of the net improvement in national savings and the impact in Australia of those substitution effects, particularly given our strong culture of consumption. If people can't provide for these things out of the public sector, they will just do it out of their own pocket, and you get the substitution effect that way.

Also, I am interested in Mr Fraser's reflection on his earlier comments on 8 August that 'the budget as such does not really have any immediate short-term implications for short rates'. Is that something that is still valid, post-budget?

Mr Fraser—The answer to the second question is yes. On the first question, we have not done any analysis or assessment as such of the net contribution to national savings that comes from compulsory superannuation or from reducing budget deficits. As you say, there are always going to be some substitution and some slippage, but I think that the measures that have been put in train over the years to move to compulsory contributions to superannuation will make net additions to personal saving. Maybe there is an act of faith in that but I think there has to be an element of compulsion in encouraging more private saving. We do like to spend, as you said, and, whilst there is some slippage with the compulsory superannuation arrangements, I think over time there will be some net additions. Similarly on the public side there is some substitution when public spending is reduced on certain activities or cut out altogether. Those activities are important enough that individuals have to fund those out of private saving, and of course that happens. But if you look back over what has been a long-term deterioration really in national saving since the 1970s and you look at where most of that has occurred, it has been very much in the public sector. It is there where the most improvement can be achieved most quickly, I think, in moving from budget deficits to balance or even surpluses, notwithstanding the kinds of slippages that occur along the way.

Mr HOCKEY—I have a follow-up on that. You referred to the budget and the short-term effect on interest rates, but isn't the budget really more aligned with some of the comments made by Mr Macfarlane earlier that we are focusing on medium-term fiscal outlook and medium-term monetary outlook, and the budget over the last few years—I am not too sure when it changed—now provides out-year forecasts and is really a four-year document as opposed to a one-year document, so isn't it the case that the budget can have some effect on short to medium term projections?

Mr Fraser—You are talking about interest rate projections?

Mr HOCKEY—Yes.

Mr Fraser—Reducing the budget deficit has implications for interest rates but they are in the medium term.

Mr HOCKEY—How long is that?

Mr Fraser—It depends on how quickly, I suppose, the budget deficit is reduced and moved into surplus and how long that is sustained and people think it is going to be sustained. But if those things happen and the current account deficit starts to improve as a consequence of national savings rising, and there is no one-for-one in all this but the directions are predictable—if all those things happen, the risk premium that is in longer term interest rates in Australia will come down. What happened in the budget a few weeks ago really does not have any implications for what happens to interest rates now or in the next six months.

Mr HOCKEY—But if the out-years are affected by any changes to the budget then surely that will have a longer term influence on interest rates?

Mr Fraser—Yes, in the markets out there. It is the markets that determine these medium and longer term rates, not the Reserve Bank. If the markets are convinced that there is substantial fiscal consolidation under way and that this is going to go on and if the rating agencies get on the back of that and endorse those moves, those kinds of things do bring about reductions in medium and longer term interest rates.

CHAIR—You are saying that the budget has no effect on the immediate thing. Is that consistent with some of the concerns you raised in 1993 when you said that if the budget did not get through the parliament reasonably soon, because it had been delayed for some time, there could be some problems with interest rates and other things?

Mr Fraser—That was a different situation. That was a situation where problems with the budget were encouraging foreign investors to be spooked and to withdraw funds. It was at that time that the Australian dollar was declining at a great rate of knots. It was through the consequences of that decline in the Australian dollar for inflation that excited attention on the part of the central bank. It was the concern about the implications for inflation that were driving those comments about the budget through the effect on the exchange rate.

Mr WILLIS—What do you see as the principal effects on long-term monetary policy in the next six to 12 months?

Mr Fraser—I think they are the things that are alluded to in here, how the assessments of what is happening to employment and unemployment develop and that, of course, depends on how the growth in the economy unfolds. That, in turn, depends upon a whole lot of things that you know about and, on the other hand, what happens to inflation. We are a bit more confident about what might happen on inflation over the next six or 12 months than we are about what might happen to growth and employment. They are the two things. It is the trends in the domestic economy that are most important in leading to changes, adjustments, in monetary policy.

Mr WILLIS—So do I take it from that that if there were to be any further reductions in interest rates that this would be because the bank would feel that the economy needed more support to maintain growth?

Mr Fraser—That is right, and that that could be accommodated in a situation where inflation was declining and the outlook for inflation was comfortable.

Mr CAUSLEY—I want to go back to the question about superannuation and savings, et cetera, and probably it is a question that goes more to Wallis and the very quickly changing economic situation we have. Traditionally, savings were deposited with banks. The banks used that money then to lend to their customers. It seems to me that there are large amounts of money now being locked up in superannuation funds. Do you see that as having a short-term effect on the ability of banks to lend to their customers like small business and housing?

Mr Fraser—No, I do not.

Mr Macfarlane—We have given this a fair bit of thought. This is an argument that has come up a number of times. It particularly came up in 1992 and 1993 when we ourselves were worried about how much bank lending to small business was going on. But, on reflection, we do not think it is a continuing problem. There was a problem that was happening then but that was because the banks were overcautious.

However, if you look at the statistics, it is true that the funds management industry is growing more quickly than bank deposits. On the other hand, bank deposits are a very stable proportion of GDP. They have not shrunk as a proportion of GDP, they have stayed very stable. The banks have got this strong growth in deposits which they can use to fund their lending. The question is: what sort of lending do they do with it? Of course, their bread and butter is really lending to small business. I see no reason that they will not and, in fact, as Bernie was saying before, at the moment they are very keen to lend to small business. They have the wherewithal because they have their deposits growing in line with GDP.

Another recent thing which is interesting is that the household borrower who wanted to borrow for a mortgage, in a sense, had a call on a lot of those resources. But now, we are seeing a proportion of that household borrowing for mortgages not coming from banks, but from the mortgage originators. So the household in its mortgage borrowing is actually moving away from banks and moving to tap that pool of managed funds. That is actually creating more room for the banks to lend to small business, which is their bread and butter. Of course, the big businesses, as they get more sophisticated as the capital market develops, can also go directly into the capital markets rather than borrow from banks. So I think banks are actually in a very good position to lend to small business as we go forward.

Mrs BAILEY—I understand at the moment that approximately $45 billion has been lent to small businesses, and that a large percentage of that has been borrowed so that small businesses can pay their tax. Do you think it is feasible that we can have a more flexible arrangement between the small business community and the Australian Taxation Office, and that small businesses can, perhaps, settle their tax at times when they have a cash flow surplus, rather than having to revert to borrowing money to pay their tax?

Mr Fraser—I am the wrong person to ask, happily. I do not really know enough about the arrangements.

Mrs BAILEY—I cannot tempt you to respond to that?

Mr Fraser—Not at this stage.

CHAIR—I am sure he has an answer, but he is not going to give it.

Mrs BAILEY—The question was: did you think that it was feasible?

Mr Fraser—Everything is feasible if there is a need for it. As I said before, small businesses borrow from banks for all sorts of purposes. They may well have their money invested in the business and be earning a greater return on that than they are having to pay in interest to borrow from the bank for a short time to pay their tax. So one cannot generalise about these things.

Mr LATHAM—I noted your comments with great interest, not only in the annual report, but in the opening remarks about the increase in globalisation of financial markets. Does this mean that the bank has increased its monitoring capacity about things happening in the United States in their financial markets? What does that monitoring show for the short-term to medium-term prospects? There is a bit of speculation that the US economy and rate movements are at a turning point. What is the bank's assessment of that?

Mr Fraser—Yes. We do monitor very closely what is happening around the globe and, particularly, what is happening in the financial markets in the United States. As I said in the statement, that tends to have fairly direct relationships here. The US economy, like the Australian economy, has been growing now for five years; it has had a good recovery; it has done quite well and, in fact, we and other countries have benefited from that. We would like to see the United States economy continue to grow at what is for them a good rate because that has spin-offs for us.

They have been closer to their capacity constraints than we have. Their unemployment rate is down around 5¼ per cent—or something of that nature—and their measures of capacity utilisation are pretty close to what most people have thought have been close to full capacity, although these kinds of things have to be pretty elastic. But, so far, they have managed to sustain all this growth without any obvious signs of inflation getting out of control. Their inflation rate has been a little higher than ours, but it is still a bit under three per cent on average over the past five years.

In more recent months, there have been a few signs that inflationary pressures have picked up—not dramatically, but a little bit. I do not know whether it is going to happen or not, but maybe the Fed is thinking about these things in the same kind of pre-emptive way as we do and as it has done itself in the past. There is another meeting of the Fed coming up shortly, on 25 September 1996, I think. The betting in the markets in the US is that the Fed might nudge rates up by ¼ per cent or something of that order.

CHAIR—I am a bit conscious of the time. We are nearly out of our official time, but we have had a couple of interruptions. Would you be happy to stay on for a bit longer?

Mr Fraser—Yes.

CHAIR—There are a few other areas we have not gone onto, such as regulation and so on. I am happy, if people have got questions, to continue with monetary policy, but I would like to try and get onto the other areas.

Mr WILLIS—I have a question about bank profitability. Your report notes that the return on equity after tax is about 16 per cent and says that that is relatively high by international standards. There is a recent report, by McIntosh Baring, doing a comparative study which shows, similarly, that the profitability of Australian banks is very high. Do you have any concerns about the high level of profitability, and do you think that this is in any way related to the relatively highly concentrated banking system that we have in this country compared to most other countries?

Mr Fraser—We can make some comments on the McIntosh results if you are interested in those. But, on the more general question of concerns, no, we do not have concern as such because the banking industry has had a couple of years of good profitability. We need a good, healthy banking sector and we have got that. The banks have recovered quite well from their problems in the early nineties and have built up their reserves and reduced their bad debts. All that is good for lending and for the economy generally.

We are also not concerned about it because we are, at last, beginning to see some competitive pressures come into play, from the mortgage originators and from other areas as well. I suspect that these competitive pressures, in time, will start to bite into the levels of profitability that we have seen in the last couple of years. Margins are starting to come down in the housing lending area, in particular. In time, that will flow through to lower profitability.

I have got people here who can talk about the international comparisons on bank profitability, and Les can also talk about domestic profitability. Ian, why don't you make some comments on the international comparisons?

Mr Macfarlane—The first comment I will make is that it was largely as a result of prompting from this committee that we did a lot of work on bank margins and bank profitability over the last few years, because the stuff we have seen published we have found to be very unsatisfactory. The conclusion that we came to was that the margins of Australian retail banks' domestic business were higher than the average of other comparable countries. They were not the highest, but they were in the top half of the range. On the other hand, the non-interest income—the fee income and the transactions income—that they got was lower than the average of those other countries.

As for that particular comparison you saw, by McIntosh, we have had a look at that and we think that they have done a few things. They have not really compared like with like. They have compared 1996 figures for Australia with 1995 figures for other countries. They have done it from an investor's point of view. They have left out some important banks in their averages because, presumably, they were not encouraging their clients to go into those. We think it actually overstates the extent to which Australian banks are profitable, although they are very profitable. As I say, in profitability, they are in about the middle of the range. In terms of their interest rate margin they are in the top half of the range.

Mr WILLIS—I thought the report said that they were quite strong in profitability by international standards.

Mr MacFarlane—Yes, well, I can tell you of some figures—

Mr WILLIS—That seems to indicate more than the 'middle of the range'.

Mr MacFarlane—That is right. That is on the McIntosh one.

Mr WILLIS—No, this is your own annual report, on page 42.

Mr Macfarlane—Certainly, the 1996 figures have been very high, and that does make them profitable by international standards. Mind you, they are in a very favourable cyclical position compared with some of the countries that we would compare them whose economies are not in quite such good shape. Their expansions have not been going as long. The summary is that it is a very profitable industry.

Mr WILLIS—Do you see any association between that and the relatively concentrated nature of the Australian banking industries, as compared with a lot of other countries?

Mr Macfarlane—I am not sure that it is extremely concentrated by other countries' standards. It is concentrated by the standards of the US. Les, you might know more about this. Nearly everyone is a bit like us. They have got four or five or six big banks. Canada is like that. The UK is like that. That is the sort of typical market structure you find everywhere outside the US.

CHAIR—Given the time, I thought we might move on to the question of regulation, if everyone is happy with that. One of the questions that first comes up is this. The Reserve Bank in the submission to the Wallis inquiry makes it clear that you would like to continue evolving from the current thing, which means that the Reserve Bank would continue to supervise banks. Should this include other areas, such as credit cards, payment systems and some of the other lenders which are currently supervised at a state level?

Mr Fraser—We think that, if there were a desire to reduce the number of regulators—and that seems to be a consideration for some people—it would make some sense to have the Reserve Bank not only continue to supervise the banks but also to take on the supervision of similar kinds of institutions, such as credit unions and building societies. They are very much like banks these days. They are supervised in the same kind of way. They have the same kinds of prudential requirements as banks have. If there were a feeling that to have one regulator for all those types of institutions rather than the two that we have at the present time, the Reserve Bank could take that on.

It would mean taking on responsibility for some 300 institutions, which together account for about three per cent of the financial assets of the country. There would be a fair bit of extra work for little real threat to the viability of the financial system; but it could be done. The submission indicates that we would be happy enough to take it on. We are not out there clamouring for the right to do so. We are not empire-building in that regard, but we could take it on. You mentioned payment systems, and they are traditionally central banking responsibilities. We think that responsibility should also stay with the central bank.

CHAIR—You do not want to put your case more strongly for why it should be the Reserve Bank and not someone else?

Mr Fraser—For payments systems?

CHAIR—For all of it.

Mr Fraser—Who wants to have a go at answering that?

Mr Macfarlane—When you say ‘all of it’, that sounds as though the word ‘mega-regulator’ is rearing its ugly head.

CHAIR—No. I am talking about banking and similar things, not insurance mutuals and the other bits.

Mr Macfarlane—As Bernie said, we are not making a play. The only things that are similar to banking, where deposits are taken from the public without prospectus and these deposits are then lent, are credit unions and building societies. They are the only things that have the same sort of characteristics as banks. We are not making a play. It would actually be quite a difficult and onerous task, but we would accept it in the interests of streamlining the system. But we are not making a play for anything.

As for the payment system, in every country in the world the central bank is the centre of the payment system, because all the commercial banks have an account at the central bank and the settlement between them occurs at the central bank. So I do not think anyone is suggesting for a minute having any model other than the central bank at the centre of the payment system.

CHAIR—Does anyone want to follow up on this?

Mr HOCKEY—I just wanted to raise a variation on Ralph's earlier question about the profitability of banks. It is an important point. As I understand it, from information provided by the Australian Stock Exchange in 1994-95, 36 per cent of all the profits of the industrial sector of the ASX were provided by banks. According to an earlier statement by Mr Macfarlane, that is going to increase, as the banks are becoming even more profitable.

Mr Macfarlane—The 1996 figure would be higher than the 1994 figure, yes.

Mr HOCKEY—That is right. Given the movement of Wallis at the moment, and the potential for megamergers, is it of concern that the banks are having an increasing proportion of the profits in corporate Australia?

Mr Macfarlane—We put a fair bit of faith in competition. It is interesting that the major instigator of competition in this area was not within the banking sector. It came from outside the banking sector, from the mortgage originators. So, when we look at these things happening and we look ahead and we see these sorts of things happening, we welcome it. We think this is competition working and this is very important.

I think some of the other discussion at the moment which underlies some of the submissions to Wallis is looking at it the other way. They are looking at these changes and they are being frightened by them. They are saying, 'There is something unfair about these changes, let's go and change the regulatory arrangements'.

We do not. We welcome these sorts of things. We always welcome competition. It clearly is going to reduce bank profits. It has reduced the margin on housing lending from over four per cent to a little bit over two per cent, over the last three or four years. So it is working. When that starts to show through in the full-year figures, I think we will clearly see a reduction in margins and, probably, some reduction in profits. We are very happy with that. Some people see this as an example of blurring, confusion or making it difficult for householders to understand what is going on. We actually welcome it. We do not think that we will have to race out and completely revamp the regulatory arrangements, because these sorts of competitive pressures are happening.

CHAIR—Can you see a similar fall in the margins for small business?

Mr Fraser—To the extent that competition is picking up, it is starting to happen. It is happening. The banks are starting to focus a bit more on small business in their lending. Small business people are alive to this and they are getting around and shopping around. That competition is having an effect on margins in small business lending as well as in housing lending—it is not happening to the same extent, but it is happening.

Mrs BAILEY—I would like to follow up on the point that was made on the regulations just before, picking up on a point that Mr Macfarlane made about blurring. In this age—in the nineties, with all the electronic advances and the blurring that has happened between banks, building societies et cetera—do you think that perhaps we should be looking at regulating the functions of these institutions rather than regulating the institutions?

Mr Macfarlane—I would recommend that you read our submission to Wallis, because that is one of the issues that we really clearly pick up on.

I do not know whether I have got enough time to discuss it but, in a sense, there are two totally different sorts of financial product out there for the public to buy, subscribe to or invest in. The first type are things like bank deposits, building society deposits or even life insurance policies, where the member of the public puts the money in and expects—in fact, demands—that in one, two or ten years time, when they come to get the money out or to claim on the insurance policy, it will be there. It has to be there, and the bank or the insurance company cannot say, 'Oh, I'm sorry, we haven't got all of it, we'll give you a part of it,' because that would just be totally unacceptable. The institution has made a clear promise that it will return your money and whatever interest there is. If it cannot do that, that institution becomes insolvent and has to be closed down. The only way you can supervise those sorts of products is to supervise the institution, because the institution becomes insolvent if it cannot meet its commitments.

On the other hand, you have another big class of products, a class which is growing all the time, which are the things provided by the funds management industry. When you buy those products, you are the one who is taking the risk. You are hoping for a high return, but you know that in any particular year you might get a low return or you might get a negative return. You might put $100 in and get $90 out. But that is the risk you took and, as long as you knew the risk you were taking, that is perfectly reasonable. That is the way the market operates.

On those sorts of products, you are not regulating the institution that provides them because the institution does not become insolvent. If I am a fund's manager who gives a poor performance and you do not get as high a return as you were hoping for, I do not go broke. There is not a run on me, and it does not have any implications for the rest of the system.

The way you regulate those sorts of products is essentially through disclosure—making sure that the public know exactly what they are getting and that the person who is offering those products does what they claim they are doing. If they say they are going to invest in shares, they invest in shares. If they say they are going to invest in bonds, they invest in bonds.

So the first group—the ones that can actually fail and become insolvent—are supervised by what we would call prudential supervision, where you supervise the institution. There is no other way. For the second group you supervise the product. You make sure that anyone who is providing an equity unit trust adheres to certain rules.

So that is why this issue of regulation is much more complicated than summarising it by a simple phrase like, 'You should supervise the function rather than the institution.' For pure prudential regulation or prudential supervision, you have to supervise the institution. There is no alternative.

Mr WILLIS—To me the bank seems to be saying—here today, in its report and in various other speeches—that the existing regulatory system is coping pretty well with the changes in financial markets, with the financial conglomerates and the blurring of traditional business lines, et cetera. Firstly, is it your position that the current regulatory system is essentially coping quite well with those changes? Secondly, do you believe that the existing regulatory system is well placed to cope with likely future changes in the financial markets?

Mr Fraser—I think the answer in brief to both questions is yes. But why don't you elaborate, Mr Austin—and hopefully give the same answers.

Mr Austin—Yes, we do think that the current system is working fairly well. We have said in the submission that it is hard to see how you would go about measuring that. The way that we have chosen to do it is to look at the outcomes of what has happened. The outcomes that we see are that the system has grown and evolved and that banks have been able to move into new fields—funds management fields—and insurance companies have been able to own a bank. It is very hard to think of new developments and innovations that have been blocked by the regulatory system. We think it is reasonably flexible, while at the same time maintaining the necessary safety and soundness for the core parts of the system which are important for financial system stability. The second part of the question—

Mr WILLIS—About the future.

Mr Austin—Yes. The point we make is that the most important thing that you should expect in a regulatory system is its flexibility, that it allows new things to develop and does not stomp on things too soon. A problem with taking an approach which tries to predict the future is that you might actually influence it. If you do a bit of crystal-gazing and say, 'We think that this might happen in the future and this might happen, and therefore we need this particular structure,' you might actually be mistaken in the way you forecast the future. The result could be that certain developments that the market might produce will be cut off in their prime. It is much more important to allow things to develop, to watch for the dangers and to react to the dangers as soon as there is any potential risk to the things that really matter in the system, but otherwise let the market do its work to provide the services to the community.

CHAIR—Could I just follow up on that? You were talking about future developments. It is obvious at least one bank now is offering services through the Internet. I suppose the question is this: does the bank have concerns about how they are going to monitor? First of all, you are obviously monitoring these developments, and I think you mentioned that, but what issues are going to need to be addressed from the regulatory point of view and/or from the consumer protection point of view?

Mr Austin—One of the things that you could say about what is happening so far on the Internet is that it is really producing a much more efficient communication device between the bank and the customer. It is very important for banks' commercial considerations, for how they go about their business. It is important for the future of their branch networks and so on. But they are essentially commercial considerations for the banks, and the regulatory issues are probably not as great as the commercial ones are.

If you look at the sorts of services already provided by a couple of banks on the Internet, most of them are just providing an information service, so you can log on to the Internet and you can see information about that bank's product. We have called it an electronic brochure; it is just information flows. There is one bank that allows customers to actually log on to their own bank account and actually make transfers between their own bank accounts at that one bank and view balances and so on. There are some issues there. They are really issues about privacy and security so as to be sure that other people cannot log on and look at your bank balance.

CHAIR—And transfer.

Mr Austin—You see, it is only between accounts of the one person at this stage. So, if you could get in there, all you could do is transfer from your savings account to your credit card account. It would still be your account. So that does not really raise that type of issue yet.

What has happened so far is like the phone in some ways. The phone is not new technology, but it is now being used much more extensively with all the banks setting up phone banking services where you can ring into some phone centre to get information on your balance, or it can be automated, and they even provide for bill paying services on the phone. It is a communication device. But it does not change the basic nature of the bank; it does not change the financial function that the bank is providing for you.

When you come to the regulatory issues, it is true that the very fact that communication is more efficient does mean that it is conceivable that, say, a bank overseas that is not regulated may be able to offer services into the Australian financial community. I suppose there are two things to say about that. Firstly, internationally, supervisors are cooperating to try and produce common standards of a high order for all banks operating internationally. So there is a fair bit still to be done on an international scale to try and make sure that those banks offer safety to people.

Probably more importantly, there will always be some that will escape through that net. There could be some bank operating from some tax haven sort of country that offers a service into the Australian community. You are probably in a situation there of buyer beware. After all, we do have that situation in Australia at the minute. We have banks which are set up as the core of the financial system, which are seen as the safest part of the system for the community to deal with—and building societies and credit unions also of that standard. Beyond that there are all sorts of other people that are free to offer financial services to people. It is essentially then for the customer to try to be sure that, if they deal with people who are not banks, not supervised by the authorities, they understand that they are taking risks.

This would be the same with a bank coming into Australia through the Internet. Frankly, we doubt that a bank of that sort, or an institution calling itself a bank coming into Australia through the Internet, would be able to attract a significant amount of business from people who probably prefer to deal with reputable institutions, especially if those reputable institutions respond to the new technology and offer genuine services to their customers which are as good.

CHAIR—We will take a couple more questions.

Mr ANTHONY—I just go back to your previous point about the blurring of the different functions and specifically retirement savings accounts. How does the Reserve Bank view that product: as a kind of prudential control or is it going to be a supervisory

arrangement that affects, let us say, so many of the securities firms?

Mr Austin—As far as retirement savings accounts offered by banks are concerned, we would view them simply as a type of bank deposit. So they fit quite neatly into the current supervisory arrangement for banks. They would have other features to distinguish them from other bank deposits, but they would be essentially taxation driven and driven by the fact that you have to keep them in there until you retire—those sorts of rules. But they are not prudential rules.

As far as prudential supervision is concerned, the banks would take the money that they get in from retirement savings accounts and invest it just like they do any other business. To go back to the earlier question, they could invest that money, and probably would invest that money, in loans for small business.

Mr ANTHONY—So, if AMP was doing it, that would come under the supervisory arrangement.

Mr Austin—No, I am talking about how we would treat banks offering these types of products. We would not allow the banks, for example, to set up a particular stock of assets which was dedicated to supporting the retirement savings accounts. Retirement savings accounts would just be like any other deposit and they would be backed equally with every other deposit by the bank's pool of assets. We would not allow the banks to move into holding a block of shares or something against those actual products.

So they would be a bank deposit. They would have the same security as a bank deposit, but they probably also have a lower rate of return that you might get in a superannuation account that you might hold with superannuation funds that are invested over a long term in shares and property and so on.

Dr NELSON—Mr Fraser, we recently were shown some smart cards and things on the cutting edge of electronic technology in banking. In the report, you said that there are a number of issues that need to be addressed before approval can be given for the trials of these. In the end, who is going to be responsible for resolving them, and will the Reserve Bank be involved before we go ahead with it?

Mr Austin—Yes; we would see ourselves as very much involved in that. At the end of the day, in many of the issues, we would not be the final decision maker. We would be liaising with other agencies that are concerned, for example, with money laundering risks that might be involved, or with privacy questions and even the other question we raised in the annual report, the question of seigniorage—the return to the government from the note issue. Although we accrue that, that is part of our profits, we pass that on to the federal government. At the end of the day, it is really a government issue to decide whether they are prepared to see competition for that source of revenue. Obviously we are involved, but we are not the final decision maker in many of those aspects. Because the banks that are involved would naturally come to us, and we would be involved in looking at the prudential issues—what implications the issues of smartcards might have and the safety and soundness of the bank—we would probably be able to coordinate to make sure that all the parts of the government that have interest in particular aspects have a chance to have their say before a scheme proceeded.

Mr LATHAM—I wanted to finish up my questions with the place where we started, unemployment, if that is okay. I just did not know how many other questions were being allowed. So this, in fact, might be the last question. I noticed, at page 13 of your report, the comments about the concentration of unemployment among certain groups. It seems to echo some of the very useful things that former board member, Bob Gregory, has had to say in this area. Can we read this to assume, in the bank's thinking, that it does not see the labour market as homogenous—the labour market does not easily clear blockages simply by decentralisation or deregulation—that there is a very strong and active role for government to play on both sides of the labour market, demand and supply side initiatives, that provide, as you put it in your final sentence here:

. . . a role for training and other programs targeted at groups figuring prominently among the unemployed

How strong a role would you like to see in future development of policy?

Mr Fraser—I believe strongly in what you have just read out there. I said before that the most effective thing that the bank itself can do to help to reduce unemployment is to sustain a good rate of growth and create jobs. Unemployment occurs these days in all strata of the community because skills are changing so rapidly with technology. It is not just one particular group of people that is affected. There are young and old people, skilled and unskilled people, blue and white collar workers: they are all equally liable to find themselves unemployed at some stage. Sustaining a good rate of growth and creating jobs is the best thing that the bank can do to help deal with the unemployment problem.

But even when you have got a good sustained rate of growth going, I suspect that that is not going to be enough to reduce unemployment to the level that we would like to see it reduced to—whatever that might be—whether it is six per cent, or five per cent, or four per cent, or whatever. And that is because the jobs might be there, but the people who are unemployed might not have the skills or the experience to make a contribution in them. It is in that context that properly targeted training programs and other labour market programs can help. They can complement the creation of solid growth and the creation of more employment opportunities. And that is really what that paragraph that you quoted is trying to say.

Mr HOCKEY—Just coming out of that, Mr Fraser: is the current account deficit at the moment an impediment to faster growth?

Mr Fraser—No. The current account deficit was 4.2 per cent as a percentage of GDP last year; it is forecast to be marginally lower at four per cent this year. It is not an impediment. No-one is too concerned about it. It is not constraining activity; it is not having an affect on the exchange rate or interest rate, so it is not an impediment.

Mr HOCKEY—So what are the impediments to faster growth?

Mr Fraser—We are growing pretty fast, that is the first thing. Can we grow faster? We probably can, given the spare capacity that we have in plants, and the spare capacity that we have certainly got in the labour market. It is a matter of being able to grow at a rate that, hopefully, will use up some of that spare capacity without running into constraints. Inflation and the current account deficit are the two traditional constraints that have caused growth to slow down in the past. They are not constraints at the moment. But any of the things that can encourage more investment, higher productivity, and more employment are the things that can cause the economy to grow faster. We have already got a forecast for investment growth of 14 per cent in real terms in the current year, and that comes after two very strong years of investment.

So we do have good growth out there, and we have had good growth out there. If we could grow a bit faster, which we probably could without running into these constraints, that would be all to the good. But there are judgments about the risks on both sides in forcing the pace too much, just as there are in not doing enough to keep it going.

CHAIR—Okay. In your submission to the Wallis inquiry, you made a mention of the quite substantial growth in derivatives used by banks. According to the chart—just looking at it quickly—in the last seven years, there has been about a fourfold increase, and it is rising. Does this build into the banking system an inherent risk factor that has not been there in the past? Is there an added risk that, if something unforseen were to occur, there would be a greater risk in the banking system than there was say seven or eight years ago?

Mr Fraser—No. Mr Austin, would you like to explain?

Mr Austin—It is true that the whole growth of financial markets, including derivatives, does link banks and increase their importance as the centre point of the financial system. But the derivatives themselves, essentially, can relocate risk between different parties and allow its more efficient management. That can be done for good or ill. It is possible to concentrate risk in a particular place and that could lead to problems, but it is also possible to use it in a sensible way to cut down risks and provide real services to businesses. A lot of the business that is done in derivatives is actually on customer account. Positions that banks take themselves in derivatives and underlying financial markets tend to be very small.

Nevertheless, it is the case that we are moving to watch what is happening there quite closely. We are incorporating market risks, as you know, into our capital adequacy framework. That includes derivatives and physical positions in markets, and covers the risks that banks might lose money due to movements in exchange rates, interest rates, equities and so on. That capital requirement is going to come into place at the end of 1997 and we have a draft prudential statement out now which details how that is going to work.

We are also putting more emphasis on analysing and monitoring banks' risk management systems so that we can be sure that they are managing these risks in a forward looking way. Our risk management teams have been working on that for some time now and we are generally quite satisfied with what we are finding. We think that the banks have systems in place that are adequate to the risks that they are running, by and large, but that there is scope for improvement.

We have identified a couple of areas where improvements can be made. There will be some further tightening up, to meet the standards that will come into place at the end of 1997, by some of the banks who are going to use their own models to calculate the capital charge. In order to do that they will also have to meet certain qualitative standards which will further improve the systems that are used.

CHAIR—Thank you very much for that. I think we have had a pretty good run here. Can I thank Mr Fraser, Mr Macfarlane and Mr Austin very much for coming along. I understand that if members of the committee do have further questions that they would like to put in writing, you would be happy to accept them and respond in due course. Those responses, of course, would be added to the comments that you have made today. Again, thank you very much.

I have had one other request which I hope you might be able to accede to and that is, could all members of the committee get a copy of the monthly Reserve Bank bulletin and also any public speeches that are made from time to time by the governor or other senior members of the bank?

Mr Macfarlane—Yes.

CHAIR—Thank you.

Resolved (on motion by Mr Anthony):

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.

Resolved (on motion by Mr Latham, seconded by Mr Hockey):

That this committee expresses its appreciation for the cooperation that Bernie Fraser has always extended to the committee and expresses its congratulations for his achievements during his term as governor. Also, the committee passes on its congratulations to Mr Macfarlane and hopes for a constructive working relationship in the years to come.

Committee adjourned at 1.07 p.m.