COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 1999-2000

FRIDAY, 1 DECEMBER 2000

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 1 December 2000

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

Members in attendance: Ms Burke, Mr Hawker, Mrs Hull, Mr Latham, Dr Southcott and Mr Somlyay

Terms of reference for the inquiry:

Review of the Reserve Bank of Australia’s annual report 1999-2000.

WITNESSES

Committee met at 11.00 a.m.

CHAIR—I declare open this public hearing of the House of Representatives Committee on Economics, Finance and Public Administration. I welcome everyone here today: the representatives of the Reserve Bank, the media and particularly members of the Wagga Wagga community. I would also like to thank the mayor very much for the civic reception he organised for the committee, the Governor and the Assistant Governors. We are very grateful for the very warm welcome we have had here. I have no doubt that the local member, Kay Hull, has been instrumental in helping with that.

In 1996 the government and the Reserve Bank agreed that twice a year the Governor would appear before this committee to answer questions about the conduct of monetary policy and issues outlined in the bank's latest statement on monetary policy, and the 1999-2000 annual reports of both the Reserve Bank and the Payment System Board form part of today's discussion.

This is the committee's first regular hearing with the Reserve Bank to be held in a regional centre. This has come about in part because there is a strong feeling in regional Australia that the Reserve Bank may be becoming too Sydneycentric and it does not give due considerations to the impact of monetary policy changes that may impact on regional areas. By bringing the Reserve Bank and the committee to a regional area, it is our hope to foster a greater understanding between the bank and the regions.

I commend the bank for the semi-annual statement. I see that there are some quite detailed comments about some of the rural issues. On page 33, there is talk about rural export revenues and references to some of the problems facing agriculture—for example, wheat and the impact of drought conditions which are quite prevalent in parts of the west, and even anticipating what problems a locust plague might bring. I hope we do not have to see too much of that, but we do know the impact the floods have had in parts of New South Wales. Of course, you go on to talk about the importance of the rural commodity prices and the fact that there is a four per cent increase in SDR terms in the September quarter and further increases in October.

As usual, this hearing will be divided into two parts, the first looking at monetary policy and the second covering other matters related to the bank's responsibility. I now call the Governor and other senior officials of the Reserve Bank.

[11.03 a.m.]

LAKER, Dr John Francis, Assistant Governor (Financial System), Reserve Bank of Australia

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

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

CHAIR—Welcome. I remind you that the evidence that you give at this public hearing is considered to be part of the proceedings of the parliament and therefore any attempt to mislead the committee is a very serious matter and could amount to a contempt of parliament. Mr Macfarlane, I believe you would like to make an opening statement before we proceed to questions.

Mr Macfarlane—Yes, that is true. I will continue the practice of starting with an opening statement. I would like to start it by endorsing your remarks and saying what a pleasure it is to be in Wagga Wagga for the first hearing to be conducted outside Sydney, Melbourne or Canberra. Like you, Mr Chairman, I think it sets a very good precedent for future meetings, even if does represent a cautious start, given that Wagga Wagga is halfway between Sydney and Melbourne and not all that far from Canberra. Perhaps the committee will be more adventurous in its future choices.

CHAIR—Other local members will stake a claim, I am sure.

Mr Macfarlane—I would also like to record our thanks to the Mayor of Wagga Wagga and his colleagues for putting on a very pleasant reception this morning, and to Kay Hull, a member of this committee, for assisting in that hospitality.

Getting down to business, as usual I would like to start by reviewing the forecasts I put before the committee at the previous meeting in Melbourne in May. Starting with economic growth, you may recall that the Australian economy grew by about 4½ per cent in 1997, 1998 and 1999. As usual, we were expecting a modest slowdown in the year to June 2000. The figure I put forward at that time was four per cent, and the outcome was 4.7 per cent, continuing our tradition of modest underestimates of economic growth. I hasten to add that these underestimates have not been by design.

Looking ahead for the year to June 2001, I said we had no quibble with the figure of 3¾ per cent contained in the budget papers, nor would we quibble with the recent update which puts it at about four per cent. I think it is largely a matter of rounding and not much should be made of small differences. The figure is meant to suggest again some modest slowing from past growth rates. I also note that the number for GDP growth involves a substantial slowdown in final domestic demand from about six per cent to about three per cent. This is mostly offset by a further swing in net exports into positive territory and the assumption that the inventory run-down recorded over the past year does not occur again.

On inflation, the story is more complicated. Last time we met I said I expected the CPI to rise by three per cent in the year to June 2000. The actual outcome was 3.2 per cent—not a very big difference, but the first time for quite a while that the outcome was higher than forecast. The reason for that was the higher than expected oil prices. When we look ahead, we should make sure that our forecasts go beyond June 2001 in order to avoid the distortion caused by the 'once-off' lift to the price level stemming from the GST. We have got to make a forecast that ends somewhere in the 2001-2002 financial year. At the last hearing I suggested that inflation could be in the upper half of the two to three per cent range once we were into that year. Our recent statement on monetary policy—this document which came out about two weeks ago—forecasts that inflation would be around three per cent by that time. So it has gone up a little. This small increase is primarily due to the lower exchange rate now prevailing compared with that in the middle of the year.

You are probably tired of being reminded that we are still in the longest expansion we have had for three decades, but that fact has to be the starting point for any economic discussion. When we receive the September quarter national accounts in a couple of weeks time, I expect to see them confirm that the expansion has continued unabated into its tenth year. During this period the growth rate has averaged 4.2 per cent per annum and most of the annual rates have been between three and five per cent, with a few outlies above and below this. That is what you would expect during an expansion. Things do not proceed perfectly smoothly, there is a fair bit of bumping about within it. Over the whole period inflation has remained low, which of course has been a major factor behind the expansion's longevity. In turn this has contributed to a fall in the unemployment rate of nearly five percentage points to 6.3 per cent. Despite this record, we should not become complacent. We should always be looking ahead to see where the risks to the outlook are likely to come from. Not surprisingly, for an economy like ours, which is in reasonable balance, the risks are on both sides. That is, while we are comfortable with our present forecast, there are circumstances which could lead to a stronger economy and hence a speed-up in inflation, and others that could lead to a greater slowdown in economic activity than our current numbers indicate.

I will start with the risks to the inflation outlook. Obviously the current year has not been an easy one in this respect. In addition to the GST induced lift in the price level, which was easily foreseeable and appears to have gone according to plan or better, we have experienced two other upward 'shocks' in the form of the rise in oil prices and the fall in the exchange rate. It is never easy to digest three such events in one year, so we have to be especially vigilant to make sure that any price rises are 'once-off' and that ongoing inflation does not rise to the point where it threatens our medium-term objectives. So far, we seem to be on track to pass this test. The GST caused a smaller rise in the September quarter CPI than expected and, on balance, the data on wages suggest that wages are growing in a way consistent with our inflation target. But there is still some way to go before we can be confident that these temporary factors do not push us off course. If it turned out that the economy was more buoyant than we think, the chances of the shocks feeding into higher ongoing inflation would rise.

I will now talk about the risks that the outlook for economic activity could be weaker than we currently envisage. Before doing so, I should remind you that our forecasts already embody a slowing in GDP growth compared to last year and a more pronounced slowing in domestic demand, so we are not oblivious to the presence of some factors which point to a less buoyant outlook than we have had over recent years. The first of these risks is, of course, the world economy, and the United States economy in particular. For some time now most observers have expected lower growth for the world economy in 2001 than in 2000 and have also expected that for the United States. But there is always a risk that the turnaround could be sharper, particularly if there is a shake-out in asset prices. No-one can be sure that after such a long expansion the United States can achieve a soft landing, but at present the odds point in that direction.

On the domestic front, the area of weakness that many people point to is housing construction. There is no doubt that there will be a big contraction in that sector. But we should remember that it was predictable and that it has been predicted by virtually all forecasters for some time. We have just gone through a period when activity in the housing sector was really quite frenzied. At its peak in the June quarter, investment in dwellings was at its highest level ever as a percentage of GDP. A lot of activity in the housing sector that would normally have taken place this financial year was brought forward into last financial year in order to get in before the GST. As a result of that effect, the housing cycle is likely to be more pronounced than normal. The rises in interest rates no doubt also played a role, but I think they were small compared to the GST effect.

The third risk that some people have focused on is business confidence. We have to be careful here because there are over a dozen surveys of business confidence and they do not all show the same results. Even so, it is true to say that business confidence is not as high as it was a year ago and it has fallen in recent months. I think the recent falls owe a lot to the realisation that the housing and construction sector will be weak, to the fact that a number of businesses have only recently had to face up to the practical implementation of paying the GST and to the rise in petrol prices.

What does the foregoing assessment of risks mean for the economy and for monetary policy? Starting with monetary policy, our main message is that we will continue to conduct monetary policy according to the medium term principles contained in our inflation targeting approach. We think this approach has served the economy extremely well, not only in the direct sense that it has maintained low inflation, but in a wider sense that it has provided preconditions for sustainable growth. We will be looking closely at all the influences on inflation over the coming year, including the demand pressures in the economy, the growth of wages and the level of the exchange rate, in order to judge how they will collectively influence the inflation outlook. Monetary policy will be then set accordingly.

We will also, of course, be closely watching developments in the real economy, the labour market, financial markets and our exports and imports. There is a wide range of statistics available on an almost daily basis from the Bureau of Statistics and from other sources which chart the course of these economic variables. You only have to read the daily press to see how much attention and prominence are given to these statistics. We at the Reserve Bank, of course, follow them in great detail, something we are able to do because we have a good staff who have had a lot of experience at examining them. But I want to suggest to you that this sort of data gazing, important though it is, is only one aspect of assessing likely developments in the economy and, on its own, can at times give quite misleading results. The problem with statistics is that, as well as containing systematic information, they also contain a fair bit of random variation and sampling error. Sometimes this means that we get a group of strong statistics arriving together, followed perhaps by a group of weak ones at some later stage, and they may really signify nothing more than the statistical anomalies referred to above. If we rely only on these statistics or recent indicators to form our view of the outlook, we run the risk of regularly swinging from optimism to pessimism and back again, depending on relatively short-term variations in the data.

Obviously, other approaches are needed to augment exclusive reliance on statistical observation and so help to identify the underlying direction of the economy. There are many advocates of approaches such as sophisticated econometric modelling, extensive industry liaison, and examination of leading and lagging indicators or of the forecasts embodied in financial prices. All of these have their merits and can provide a broader perspective, but there are two other approaches that I would like to refer to today, which I find important.

The first is to go back and examine previous expansions and ask what were the imbalances that brought about their demise, and then to see whether these imbalances exist at present. I did this earlier this year in a speech in Melbourne, where I identified a number of domestic imbalances in previous cycles. High inflation was one, a wage surge another, overvalued asset prices another, excessive physical investment another and excessive credit growth another. Not all of these were present towards the end of earlier expansions, but usually two or more were.

In looking at the Australian economy at present, it is hard to see evidence of any of these imbalances. Underlying inflation is about 2¼ per cent, rising to three per cent over the forecast horizon. Wages are growing somewhere between three and four per cent, which is consistent with our inflation target. The share market has risen over the year, but does not seem overvalued compared with many overseas markets. House prices have risen over recent years also, but appear to be stabilising at present, while commercial property prices have remained reasonably restrained throughout. There has been no evidence of overinvestment or the creation of overcapacity in plant and equipment or construction. Finally, credit to households, whilst it is still growing strongly, appears to be moderating and credit to businesses has not been unduly strong at any stage in recent years.

So, overall, I think it is hard to find signs of the types of imbalances that occurred in the early 1970s, the late 1970s/early 1980s or the late 1980s which led to such unhappy results. Many people would add the current account or the balance of payments to my list and point out that in the later stages of previous expansions fast economic growth led to a widening in the current account. Again, we are different this time in that the buoyant domestic demand growth we have experienced over the past year has been accompanied by a decline in the current account deficit.

Of course, I have only listed domestic factors that give rise to imbalances and imperil the expansion. As I said earlier in my introduction, the world economy plays an equally important role, and we have no control, or even influence, over that. It is possible to construct disaster scenarios for the world economy, and no doubt some will, but I am comfortable sticking with the majority in assuming a modest slowdown in world growth or, in current parlance, a soft landing. No two economic expansions are the same. Each of the previous ones differed and the present one has its own unique features. As a result, we cannot rely only on cyclical comparisons such as I have just presented, but they are a helpful part of any overall assessment.

A second approach, which I think is a useful reality check, is to look at how the present setting of policies is affecting the economy. On monetary policy, there is a tendency for attention to be focused on changes in interest rates, even when each change is quite small. It is at least as important, I think, to look at the level of interest rates in nominal and real terms and ask whether their present setting involves a significant risk that the economy will overheat or contract. As you know, a year ago we thought that the continuation of the then setting of interest rates would risk the former outcome. That is why we moved to our present setting, which we would characterise now as being more or less in the neutral zone—that is, not presenting either of the two risks to any substantial extent. Because it is in this zone, there is no overwhelming case to move it in a particular direction at present. Overall, the main point for present purposes, I think, is that you could not claim that the current setting of interest rates is inhibiting the growth of the economy.

Another important influence on the economy, which is often put under the heading of monetary policy for convenience, is the level of the exchange rate, although it is obviously influenced by many more things than monetary policy. I do not wish to spend much time on this subject in my opening address today because I devoted a whole speech to it less than a month ago. Suffice to say that I do not think there is anyone who would deny that the current level of the Australian dollar makes our exporting and importing competing industries super-competitive, and hence is exerting an expansionary influence on the economy.

On fiscal policy, the need to more than compensate consumers for the imposition of the GST ensured that it moved in an expansionary direction between last financial year and the present one. Again, I think we can all agree that, even though the budgetary position will remain in surplus for medium term purposes, the current stance of fiscal policy is not imposing a contractionary influence on the economy at all.

Overall, therefore, I conclude that, because the economy has not developed the imbalances of the past, it has not been necessary to attempt to remedy them with the sorts of countermeasures in the fiscal and monetary areas that were often needed in the past. This is another way of saying that we have, in my opinion, avoided the boom-bust cycle in economic policy, and hence have an excellent outlook for the coming year. I have no further comments to make on the economy at this stage but will be happy to answer questions.

The only other point I would like to make concerns the economics of banking. In the past we have often provided to the committee, at their request, a paper on banking subjects such as bank margins or bank fees and charges. On this occasion there is no special paper specifically for this committee, but we have recently finished a major study, in conjunction with the ACCC, on interchange fees in credit and debit card schemes, and we will be happy to answer any questions you have on that study.

CHAIR—Thank you very much, Mr Macfarlane. We will come back to the study of debit and credit card scheme interchange fees later, but we will start the questions on monetary policy. I would like to preface my question by saying that I am sure everyone would be very heartened to hear your concluding remarks when you say that you believe that we have an excellent outlook for the coming year. I think it is always very encouraging to hear that. In your opening remarks you talked in the beginning about some modest slowing from past growth rates, and you then went on to say you are comfortable sticking with the majority view in assuming a modest slowdown in world growth or, as you said, a soft landing. If you look at the official cash rate of 6¼ per cent, the 90-day bank bill of 6.28 per cent and the 10-year bond rate of about 5.8 per cent, do you think this would indicate a reasonable expectation that there should be an easing of interest rates in the coming year?

Mr Macfarlane—The characteristics of interest rates, or the yield curve, that you talked about, are a worldwide phenomenon. In fact, in Australia it is probably less pronounced than it is in the US. If we go through the year—I will start with the US and then move on to Australia—we see that in the first half of the year there was a general expectation that the US would have to put up its short-term interest rates quite a lot. Because of that expectation, the interest rates that were a little bit longer than the overnight rate, or the Fed's funds rate as it is called in the US, were well above the interest rate that the Fed set because this was the expectation, that further big increases might be required. Around the middle of the year in the US the realisation started to dawn that maybe US interest rates had gone up as far as they needed to go because the economy was slowing, there were some signs of slowing, and, as you would be aware, the share markets have come down. First of all, we saw in the US this flattening of the short-term yield curve and then more recently, in the last two or three months, we have actually seen the 90-day rates in the US being below the Fed funds rate, indicating some expectation—not a certainty but some probability—that the next move in US interest rates will be downwards. That is the backdrop against which all the local developments occurred.

In our case, because of a number of factors, an important one being the falling exchange rate and the feeling that that would exert upward inflationary pressure, these developments occurred much more slowly in Australia. So it has only really been in the last very short period that our 90-day rates have come down to equal our overnight rate. In other words, in Australia the expectation of further rises in interest rates continued a lot longer than in the US. But you are right to observe that at the moment the structure of Australian interest rates out to 90 days or 180 days indicates that the market is not assuming that there will be a rise in the interest rate that we set during that period. In that sense, our markets have behaved somewhat similarly to the US markets, but with quite a lag.

The other issue you pointed out is why are bond yields lower than the short-term interest rates? It is very pronounced in the US, but it is also happening here. There are several explanations for this, and I suppose the most plausible one is that the markets as a whole believe that some sort of slowdown is going to occur and that inflationary pressures are going to diminish. These rates you are talking about are 10-year bond rates, so this is an expectation that goes over quite a longish period. That is the first explanation. The second explanation, particularly for the fall of bond yields in the last six months or so, is that I think there is some evidence that funds managers have lost some of their former enthusiasm for equities and are diversifying towards holding bonds because they do not think the big capital gains they used to get in equities are going to be there any more. It is a combination of those factors.

CHAIR—You have probably seen today's *Australian Financial Review* headline which talks about 'US: now the slowdown: markets eye interest rate cut'. If that were to be the case in the United States, how soon would we expect that to flow through to Australia?

Mr Macfarlane—I prefer normally not to address my remarks to what was a headline story in a particular newspaper, particularly since I do not think there is really anything new behind that story. All that story is talking about is the sorts of processes that I alluded to in my earlier answer to your question. It is no doubt true that as the last three or four months have progressed there has been more evidence in the US from various markets and from various surveys there that the extreme optimism and the very rapid growth that had been occurring during 1999 and the first half of 2000 is slowing down. This is not a bad thing; this is actually a very good thing. This is what we have all been sitting there waiting for. The big danger was if it had kept going and had so much momentum that it could only be controlled with very big increases in interest rates.

So what we are seeing is actually a very good outcome for the US. It is evidence that this soft landing is occurring. As more and more of this evidence comes in, the markets are pricing in some possibility of cuts in interest rates. Some of them are going a bit too far in this respect. There is a tendency in the US for some market participants to think, ‘The stock market is falling, we notice the NASDAQ is down a long way and all the other US indices are down,’ and I think there is a tendency for some people in the financial markets to think, ‘Isn’t this a terrible thing? The stock market is down. The Fed is therefore going to have to lower interest rates.’ I do not think that is the way the Fed operates. The Fed is looking at a far broader measure of the American economy than the stock market. But, because some other people have got that narrower focus, I think that has exaggerated to some extent the tendency for the markets to expect easings in US interest rates. They certainly do. They expect in the US that the next move in interest rates will be down.

CHAIR—If it were to transpire, would Australia be likely to follow that direction?

Mr Macfarlane—It has to be the case that, if the world economy is growing more slowly, while inflationary pressures are coming down and world interest rates are coming down, it would be an excellent environment for us to make policy. The interest rate outcome we would get for Australia in that sort of environment would be a lower one than if the environment of the first half of the year 2000 had continued.

Ms BURKE—In your *Statement on monetary policy* at page 13, looking at the US in particular on interest rates, you do talk about the inverse yield curve and normal expectations of the market. You also say there are contradictory factors like the US surplus. Looking at Australia’s surplus and all those other factors, given what you have just said, taking into account Australia’s particular economic cycle at the moment and also the GST lag effect in inflation, can you really give us a solid commitment—or impact—that we are looking at the factors in the US flowing here? Don’t we have a set of particular circumstances to ourselves at the moment with the GST lag?

Mr Macfarlane—You are right to pick me up, and in fact I did not mention an additional factor that is operating both in the US and in Australia. Because the actual supply of government bonds is going down, people are keen to buy what is available, which pushes up the price and pushes down the yield. So just looking at government bonds as the indicator of the yield curve does exaggerate the extent to which it is downward sloping. You are absolutely correct to add that. But that is an effect that is operating in both countries, because we both have budget surpluses and we both have a declining stock of government debt.

As for the GST effect, clearly it has not had a significant effect on bond yields, otherwise our bond yields would not have gone down as much as they have. What I am saying is that the capital markets have made the judgment that the GST effect is a once-off kick and that it is not going to cause a permanent rise in the rate of inflation.

Ms BURKE—So you would agree it is a once-off hit? From where you are sitting at the moment, the Reserve Bank is saying the GST spike is a once-off hit, there is no lag effect?

Mr Macfarlane—We have said all along, as you are aware, that we are working on the assumption that it will be a once-off lift and that it will not feed through into ongoing inflation. The jury is not completely in on that, but what we have seen so far indicates that is still the most likely outcome. The fact that the bond market also accepts that I think is further evidence that that is the most likely outcome.

Ms BURKE—In the *Statement on monetary policy* you mention businesses having absorbed a lot of the GST impact themselves, and the flow-on effect, say, in the second half of next year when they actually have to up their prices, or a lot of small businesses go bust. We are seeing the start of that sort of trend at the moment. Are you concerned about businesses having absorbed it and the longer term impact that that is going to have?

Mr Macfarlane—There are three different ways of explaining the fact that the rise, as best as we can tell, in the September quarter was smaller than most of the arithmetic predictions had suggested. The first one is just that the original estimates were wrong. Another explanation is that much more of the effect of the reductions in wholesale taxes came through and made themselves apparent in the September quarter. The third explanation is that a lot of businesses absorbed part or all of the GST and did not let them flow through into their prices. If the third explanation is correct, then either the quarterly pattern of price increases over the next three quarters or so may be a little higher than we had originally thought as businesses do pass them through into prices, or, if the circumstances are so competitive that they feel they cannot pass them through into prices, yes, that will have a slight contractionary effect on the economy.

Dr SOUTHCOTT—What do you expect the composition of growth in the domestic economy to be over the next 12 months,?

Mr Macfarlane—The biggest single compositional change that is going on is one really strong sector and one really weak sector. You do not need a lot of imagination to know what they are. The really weak sector is housing. Because we had this massive boom in housing and it sucked forward a lot of housing activity which would otherwise now be occurring, I think it is right to say that our forecast just for the effect of the decline in housing will take over a percentage point off GDP growth. That is the bad news—but predictable bad news.

The good news is the external sector, particularly exports. We had a figure that came out for exports on Wednesday which was an extremely good figure which surprised everyone. What it means is that, if you look at exports for October, there is a little bit of Olympics effect in that so you take that off, and you go back to last October and there was a special factor there and you take that off. Then, when you calculate the growth in exports over the last year, it is 30 per cent, which is an extraordinarily high figure.

So the main compositional change is weaker house building and very strong exports. The good thing for the economy is that house building is about five per cent of GDP and exports are about 20 per cent of GDP. So the one that is doing well is a much bigger part of the economy, although it is not necessarily a part that gets recorded a lot. I think you will find that a lot more column inches of the newspapers will be devoted to what is happening in the house building industry than what is happening in exports.

Dr SOUTHCOTT—You mentioned in your opening statement that over the next year you expect to see a slowing of global growth but at the same time you expect to see exports growing quite rapidly. Is that because of the increasing competitiveness due to the Australian dollar falling in trade-weighted index terms and also against the US dollar?

Mr Macfarlane—The first thing is that, even though we talk about a slowing in global growth, it is still a very good growth rate. We are talking about coming down from 4½ per cent to four per cent for world growth, and four per cent is a very good growth rate. It is not as high as it is in 2000 but it is a very good growth rate. So, other things being equal, you would expect that to provide a good backdrop for our exports. Then, of course, if there are further effects following through from the currency, although we do not know what the currency will be at any particular time, that will also contribute to strong export growth.

Dr SOUTHCOTT—What do you expect the growth outlook to be for Asia, Japan and non-Japan Asia?

Mr Macfarlane—There is a bit of pessimism that has arisen recently about Asia and I think people are exaggerating it. The areas about which you have a right to be pessimistic are Thailand, Indonesia and the Philippines, which have a great deal of political instability. In the case of the Philippines, I think that its main problem is political instability, but with Indonesia and Thailand, who have also got political instability, there is a disappointment about how tardy they have been in cleaning up the mess which was their banking system. I think the criticisms of those three countries are probably correct, but it is not correct to say, ‘They are going to have another 1997 Asian crisis,’ because you can only have a crisis like that if you are coming off grossly inflated asset values. They may have problems that mean they are going to continue to be sluggish but they do not mean they are going to have another 1997.

More importantly, the economies that really matter to us in Asia are Japan, China, Korea and Taiwan. They are the northern Asian economies. They are the ones that are big and they are the ones that receive so much of our exports. My reading is that they are still in reasonable shape. I am not saying that Japan is going great guns but I do not think it is going to do any worse than it has done over the last decade. In fact, it probably will do better than it has done on average over the last decade. China is chugging along reasonably well—despite every year someone saying it is going to fall in a hole, it still chugs along quite well. Korea may not have the exceptional growth rates that it had when it came out of its recession but I think it will continue to grow at a reasonable rate. I think the pessimism about Asia is overdone because people have extrapolated from three quite small economies—Thailand, Indonesia and the Philippines—and ignored the fact that the bigger ones are doing okay.

Mr LATHAM—Mr Macfarlane, I just want to follow up a couple of observations in your opening statement regarding fiscal policy. You said that the need to more than compensate consumers for the imposition of the GST ensured that it moved in an expansionary direction between the last financial year and the present one. How much upward pressure on interest rates was generated by this expansionary stance?

Mr Macfarlane—I do not believe there was any. I have answered this question a few times before, so I will have a go at it again. Fiscal policy can have a very big impact and have big implications for monetary policy in two circumstances. The first circumstance is when you have just terrible fiscal policy—great big budget deficits that no-one knows how they are going to be financed and there is great scepticism about the whole logic of government policy. This has a terrible impact on people's expectations and on overseas investors and all the rest. We have had that about three times in the last 20 years. As I said on the previous occasions, both parties can claim credit for being involved in that. But we are not in that situation now—far from it. We are in a situation where we are in our fourth year of budget surplus. No-one can say that we do not have fiscal credibility in Australia. In fact, internationally people look at a few simple indicators—like four years of surplus and debt to GDP—and they say, 'Australia is in the good camp; Australia is among the good guys.' So we do not have that problem.

There is a second circumstance, which is not disastrous but is a more normal circumstance, where fiscal policy can have big implications for monetary policy. That is when it has an impact on the actual growth of the economy and if it has a destabilising impact on the growth of the economy. For example, if the economy was growing very fast, and already perhaps you were worried about the upward pressures on inflation that were coming from this fast growth, and then the government brought down a budget which gave a fiscal expansion, you would be very worried that that would be enough to tip it over into excessively strong growth and lead to an inflationary fear, in which case you would have to meet that with a tighter monetary policy. Similarly, if you had a very weak economy and the government had a very sharply contractionary budget, then you would think that would weaken the economy even further and inflation would go down, and so you would respond probably by lowering interest rates. I do not think either of those two situations applies at the moment. We are saying that domestic demand, which was growing at six per cent, is slowing down to three per cent. That three per cent actually includes the expansionary effect of those tax cuts that came in on 1 July. In that sense, either through good management or good luck, the changes in fiscal policy have actually moved us in a stabilising direction rather than a destabilising direction. So I do not think the changes in fiscal policy have meant we have got to have a meeting to decide what we do about this and whether to put up interest rates. It is not the situation we are facing.

Mr LATHAM—In your opening statement, though, you were talking more about the immediate past than the future. In August you gave an excellent speech to the Queensland University of Technology where, amongst other things in the question and answer session, you said, 'Obviously any component that is boosting the economy will, other things being equal, put upward pressure on interest rates.' If there is an expansionary stance in the immediate past in fiscal policy, is it not self-evident from that statement that it puts upward pressure on interest rates, all other things being equal?

Mr Macfarlane—There is a sort of a game that is played. We do not play it but it does tend to get played in Canberra. It tends to look at economic policy as though the whole aim of economic policy is to make sure that interest rates never go up. In that view of the world, anything that is expansionary, other things being equal, is likely to cause interest rates to go up. In that view of the world, you would be very upset if you had a big boost to exports or if a businessman went out and did a whole lot of business investments, because all these things would be expansionary and, other things being equal, anything that is expansionary will put some upward pressure on interest rates. So you end up in a world where you worry about anything that is expansionary. But these things are good things: high exports are a good thing and high investment is a good thing. If the economy were growing below a nice sustainable growth, expansionary fiscal policy would be a good thing. So with all these things which we look upon as good things, if you were a total pessimist you could say, ‘I don’t like any of those because they put upward pressure on interest rates.’ That is what that statement says. Anything that is boosting the economy which usually we look upon as a good thing, if you really want to be a misanthrope you could turn around and say, ‘I don’t like any of those things because they are putting upward pressure on interest rates.’

Mr LATHAM—I like the way the economy is headed. I think we can be happy about that, but it is good to know the different influences on monetary policy, and that was the purpose of my question. In your opening statement you said that at the moment fiscal policy is not imposing a contractionary influence on the economy. Does that mean it is expansionary; if so, are you happy with that?

Mr Macfarlane—Yes, I have said that before. The movement from last year’s budget to this year’s budget did provide a stimulus to the economy. I have said that on many occasions. There is no doubt. What I am saying is that, through good luck or good management, the timing is very nice because it is helping to keep the economy on a growth path that we think is a good growth path.

Mr LATHAM—Just looking to the future, next year being an election year, is there room for even greater expansion in the stance of fiscal policy? I notice the government has a list of spending proposals—$1½ billion on defence, the announcement on roads, welfare reform and R&D—and the alternative government has a big commitment to what is known as the knowledge nation agenda. Would you be concerned about a bidding war as the election comes down to a question of how the surplus is spent rather than how the surplus is protected?

Mr Macfarlane—Yes, I would be concerned about a bidding war. I have said that before and I repeat that now, that I would be concerned about it for all sorts of long run reasons to do with our national savings, our capacity to invest for the future. Other than in very weak years, that is, recession years, I think it is important that governments run surpluses. I would be very disappointed if, in the environment of quite a good year of growth, a four per cent year of growth, we ended up in a bidding war. I think that would be very disappointing. If it was on a very small scale, you could not complain, but at some point, yes, it would be very dangerous.

Mr LATHAM—Finally, could I just go to another observation in the opening statement. You have mentioned that monetary policy settings at the moment are characterised as in the neutral zone. I am sure that from the other statements our friends in the media will be reporting that interest rates are on hold. I seem to remember from our last hearing that the same thing happened, and then at a gathering in response to that reporting you said that was a correct interpretation, that interest rates were on hold. That was in May, but by early August interest rates went up. It left me wondering how long do they stay on hold and what sort of time period we can put next to that observation that they are on hold.

Mr Macfarlane—I never did say they were on hold, I can assure you of that. It is true that in my mind it was very easy to classify the stance of monetary policy in the second half of 1999 as being expansionary and there was a need to move away from that expansionary stance to something which is more neutral. It is very difficult to know exactly where neutral is. You sometimes feel you are there and you discover you are not. But I think the chances of our getting this right are higher this time than on previous occasions.

Mrs HULL—Governor, you spoke in your opening statement on the current level of the Australian dollar making our exports super-competitive and indeed exerting an expansionary influence on the economy. You have also referred to Japan as one of our major trading partners. In terms of being a strong trading partner, my information is that Japan seems to be in some decline due to declining birth rates, et cetera. We also have the issue of the floods that are currently sweeping across northern New South Wales which will have a great impact on exports, bearing in mind that most of that is lost at this time. Would you like to expand on how you think that this might impact on Australia, bearing in mind that we are going through this great expansionary influence within the economy due to our exports and the low dollar?

Mr Macfarlane—I think we have done remarkably well. Our exports have done remarkably well and the economy has done remarkable well over the last decade when you consider that our biggest trading partner, Japan, has been so sick. I sometimes read things about Canada which say, ‘Oh, Canada has done very well,’ and I think, ‘That would be easy, wouldn’t it, having the United States there, which takes 80 per cent of your exports, just powering away underneath you?’ Similarly, I have heard assessments of New Zealand and have thought, ‘That is pretty easy for them because they have got Australia sitting there beside them as their biggest export market which has been growing at very good rates for the last decade.’ Our biggest trading partner has been very sick for the last decade, yet despite all that we have produced a very good export performance. I cannot, off the top of my head, tell you what our average growth of exports was over that period. Glenn, have you got it in your head?

Mr Stevens—Eight per cent or so in volume terms.

Mr Macfarlane—It was eight per cent per annum in volume terms. It has been a great performance, considering that our biggest market has been very weak. That is why I would be very optimistic about exports for next year. Japan is not going to be any weaker than it has been in the past—it is probably a bit stronger—the exchange rate effects will still be coming through and the rest of the world economy is growing at four per cent or so. Despite the unfortunate effects of, for example, the droughts in Western Australia or the recent flooding in New South Wales and southern Queensland, I think there is not much doubt that it will be a very good year for exports again next year.

Mr SOMLYAY—Mr Macfarlane, in relation to your opening remarks on the housing and construction industry and your reference to pessimists—that pessimists often find their dreams come true—do you think that if market expectations on interest rates translated to consumer expectations on interest rates that that would revive the housing sector and that perhaps we ought to be taking a more optimistic view rather than a pessimistic view?

Mr Macfarlane—The history of the housing sector, whether over the last decade, two decades, or three decades, is one of boom-bust. The amazing thing about it is that it was always like that. Even when we had a heavily regulated financial system, it had these big cyclical swings. Now we have got a deregulated one and we still have these big cyclical swings. At graph 25 on page 26, you can see that the upswing this time in ‘volume’, ‘commenced’, ‘work done’ has just been huge. I myself cannot see any reason why the big cyclical swings will stop. As I said, this particular cyclical swing may be more pronounced than previous ones because, as well as the normal cyclical swing, you had the GST bring forward. I think that the fact that there is going to be a big fall in housing starts is already determined.

At some point, it will turn around and the upturn will start again. But these swings are so big that it is hard to conceive of a financial scenario that would have a very big impact on that in a short time. You could ask, ‘Would it help if you had incredibly low interest rates?’ The truth is that the only circumstances in which you would get incredibly low interest rates is if you had an incredibly weak economy—and that would not be of much help. I am afraid that the cycle in the house building industry has been almost predetermined. Once all that work that would have been done this financial year and perhaps even a little longer was brought forward into last financial year, it pretty well determined there was going to be a big swing in the house building industry.

Mrs HULL—Still on page 26, we move on after the dwelling sector to the business sector. We speak of the declining confidence—from the high levels seen at the end of last year down to low—and allude to the fact that, according to a Yellow Pages survey, confidence of small business has also declined sharply in the first half of this year, although much of that decline was reversed in the September quarter. It appears that there is still this pessimistic view in small business in particular. Would like to comment on how that confidence could be restored and what needs to happen for it to be restored.

Mr Macfarlane—There are a huge number of surveys that are taken of business confidence—I think I counted 13 separate surveys—and a lot of them asked more than one question. There are about 160 different sets of numbers you could get that chart business confidence. My observation is that in virtually all of them the characteristic they have is that the latest observations are that confidence is down, obviously compared to 1999, which was a year of extremely high confidence. But in all but about two of these 13, the current level is not particularly low. It is not as low as it was, for example, in 1998. Most of them were lower in 1998 than they are now. A lot of them were lower in 1995 and 1996 than they are now.

What we are seeing on most of these measures of business surveys is some loss of confidence but nothing particularly startling. You did mention the Yellow Pages. That is one of the two where the latest observations are a good deal weaker than some of the earlier ones during the expansion. The question that then arises is: since that deals specifically with very small businesses, what is really upsetting small businesses that is not upsetting big businesses very much? I am not sure what the answer to that is. One possibility is that in the introductory phase of the GST small businesses are finding it more difficult to cope than bigger businesses, for example. That may well be.

The problem is that with most of these surveys they ask people what they think about the present or what they think about the future. When they get the results, if it has gone up or it has gone down, then the person who compiles the survey comes up with an explanation, but the explanation really has no scientific basis, they just make up the explanation. All the survey tells you is whether people are feeling more confident or less confident; it does not tell you why they are feeling more confident or less confident. We really never know what it is in detail that is bugging people.

Mr LATHAM—Do you ever put a lot of weight on these surveys? What reaction do you have to some of the hysteria that comes from the industry groups following each survey? If you had taken ACCI’s advice 18 months ago, growth would be heading towards five or six per cent and inflation ripping and tearing. You have mentioned in different speeches that probably on its forecast the bank has been undershooting, but your critics undershoot by even more.

Mr Macfarlane—You have to treat these things with a great deal of care because you do not know how much statistical thoroughness has accompanied them. It is not as though they are done by the bureau, which we have some confidence in. Some of them are done by banks or private sector firms which do it as a sort of public relations exercise, a means of becoming known. Some of them are done by lobby groups and, when the results are announced, the accompanying commentary is obviously directed towards their constituents. You have to be very careful, particularly as there are 13 of them. The idea of just picking only one of them and saying, 'Look what is happening to the economy. This one said such and such,' is very dangerous. I do accept that the level of business confidence has come down compared with what it was last year, which was a period of very strong confidence. It has not come down in a way that would alarm me because it has not come down, in most cases, as much as it did, for example, in 1998—and 1998 turned out to be a very good year—or as much as it did in 1995 and 1996, which were quite good years. So, yes, there has been some reduction in business confidence but you would have to work very hard to come up with an alarmist message from it.

Mrs HULL—Bearing in mind that small businesses are the greater employer of people across Australia, should it not be taken more seriously and more work undertaken to determine just exactly the reasons why? If confidence is low and there does not appear to be an understanding as to why, then surely that has to be a problem for the future in employment prospects?

Mr Macfarlane—You are right. Small businesses are very big employers. If there are things that are making small business less enthusiastic than large businesses, it would be worthwhile knowing. My guess is that it is not going to be the macro economy-wide factors that we look at. It is going to turn out to be something that is much more specific to the way small businesses are run—whether they can hire or fire or something to do with their taxes. It is going to be something which is very specific rather than something which is broad.

Mrs HULL—Would you consider looking at this issue in more depth? My interest is in the small businesses of Australia and their continued employment success. It might be relevant for you to take a closer look at it.

Mr Macfarlane—That is a good point. I will take that on board. It would be very interesting to do some study on that.

CHAIR—We take it that you might have something for the next hearing.

Mr Macfarlane—Yes.

CHAIR—You have talked about the United States powering forward, that it is 23 per cent or almost a quarter of the world economy. In relation to the current impasse—if you can call it that—in the presidential elections, are the markets starting to factor some uncertainties into their thinking, both in the short and medium term? You might not want to comment on political things, but it is part of the whole economic scene. What impact do you think that is going to have?

Mr Macfarlane—I myself think, somewhat perversely, that it has almost had a good impact, not just from Australia's perspective but also from the perspective of any of the European countries, for example. The thing that was worrying us all was this incredible capacity for the American economy to seem to charge ahead, for everyone to want to invest their money in the US, for the US dollar to charge ahead and for US share prices to charge ahead. It had all the makings of a serious unsustainable boom—which would be dangerous for the US and indirectly for us—and it also made the job of other countries running their economies more difficult. During 2000, there have been a lot of people—and not just in this country—who have been praying for some relief from this. In other words, they were looking forward to some of the steam being taken out of the US stock market, some of the steam being taken out of the US economy and some of the steam being taken out of the US dollar.

We are gradually seeing that starting to happen. First of all, the stock market really peaked in March. We have had some falls—all of the indices have fallen since then. The NASDAQ, which is the most glamorous one, of course, has fallen by the most. We have seen more evidence that the US economy seems to be hitting a soft landing, as I explained earlier, and that has been a relief. We are now quite possibly seeing the first signs that there are some big players out there, some big funds managers, who are having doubts about the US dollar; they feel that it has gone too far. We saw evidence of that last night and earlier in the week. If the political uncertainty in the US has in some sense contributed to this, it has probably done so in a stabilising direction, making it a bit easier for the rest of the world and probably helping to bring about the sort of soft landing and slight winding-down in asset prices in the US that people would recognise as a good thing in the long run.

CHAIR—Let us follow it through a bit further. You have seen that impact so far but, if that uncertainty continues with either a weak president or something else, is there a possibility that there could be an overreaction?

Mr Macfarlane—That is possible—if you had four years of a very weak president. Maybe if we were coming back in a couple of years time, we would be thinking very differently to the sort of presentation I have just given. Yes, we could not rule that out, but I do not think I would want to speculate that far ahead.

Ms BURKE—There are contradictory indicators in all that for Australia, though: the Australian dollar is low and our exports are doing well because of that, and there has been some speculation that the Australian dollar will rise because the US dollar is going to fall. It is almost like 'our currency is going to do okay if theirs does badly', which were the fundamentals of your CEDA speech as well. So is there a contradictory nature in that—if our dollar goes up, inversely, our economy is going to suffer? Where does that all lead, and how is it sustainable for our economy overall, given that, for the last two years—before I was on this committee—we have been talking about the miracle economy based on retail spending? Now it is down, and we probably all knew that it could not last forever. Given the GST implication in retail spending overall, where is the economy going, how can we predict it and what is a level of sustainable growth for Australia into the future?

Mr Macfarlane—Going back to your first point, I would agree with the majority of people who would say that the Australian dollar is actually undervalued and that, for the overall balance of the economy, it would be better if it were not as undervalued as it is—although, however low it goes, you can always find some people who say, ‘This is great for exports; let’s make sure it stays there or goes even lower.’ I do not think that is the right approach; we have got to have a balance in all things. If the US dollar were to fall, it would be good for the world economy and it would be good overall for us, even though it might take some of the supercompetitive edge off the exporters and the import competing industries.

Ms BURKE—If the Australian dollar is undervalued, what do you reckon its true value should be?

Mr Macfarlane—I cannot respond to that.

Ms BURKE—You led! You gave me the option there.

Mr LATHAM—Mr Macfarlane, in your semi-annual statement it was recorded:

On balance, it would be surprising if, in the event of the recent currency depreciation being sustained for a significant period, this did not add noticeably to domestic inflationary pressures. The inflation outlook will therefore depend importantly on how long the lower exchange rate is sustained.

That was six months ago and it was also at a time when the Australian dollar was at a value five cents higher against the American dollar than it is now. Are we looking at noticeable and important inflationary effects? How much inflation is sitting on the docks?

Mr Macfarlane—You are right that the Australian dollar has depreciated since then, and our inflation forecast did go up since then. But, in that most recent period, the depreciation of the Australian dollar against the US dollar overstates the extent to which inflationary effects will be coming in. We have not depreciated against the TWI to anywhere near the extent that we have against the US dollar. But it is true that we still have depreciated a bit against the TWI and that is carried through in our forecast for inflation.

Mr LATHAM—Are you worried about a clear explanation of the behaviour in our currency for the last six months? The statement for this meeting is very clear about the first six months of this year and what happened—how our currency movements were linked to events or statistical announcements. I know it is not an easy task, but your assessment for the last six months looks like a bit of a Bermuda Triangle in terms of economic theory and understanding what is actually going on with our currency. Is it a major concern that it is acting outside all past and predictable behaviour?

Mr Macfarlane—I went through that in that CEDA speech, and I was prepared to say that things were happening that we could not explain clearly. A lot of people said, ‘This shows that the governor is completely befuddled and hasn’t got a clue what’s going on.’ So much for honesty. Things have happened, particularly in the second half, that have been much more difficult to explain than things in the first half. But at the end of that CEDA speech, I concluded that I thought the main reasons for its behaviour from mid-year until about a month and a half ago—it has essentially been stable over the last month and a half—were, firstly, just a straight strong US dollar; secondly, just straight momentum—because we know that exchange rates do follow momentum—and, thirdly, that a number of investors were influenced by the new economy-old economy distinction. As I said, I think that they exaggerated it shamefully and that the similarities between the US and Australia are much greater than the differences. But the way people perceived it was to concentrate on the differences, and that was also a factor at work. So there was a period when you had to go out and look outside the normal traditional explanations for an exchange rate movement, and that period was from, say, July-August until early October.

Mr LATHAM—On those market perceptions, you have noted in the past that deteriorations in the currency have normally been associated with the lax fiscal and monetary policy. You said today that fiscal policy has been expansionary in the immediate past, that you have been undershooting on your forecast for monetary policy and that, by implication, there has been an undershoot on interest rate movements as well. Do you think there is a market perception that things are a bit loose in this country and have been so for quite some time, either on the fiscal or the monetary front?

Mr Macfarlane—No, I do not. When I say that in the past loose fiscal policy may have been associated with a falling exchange rate, I am referring to periods when we had really large budget deficits and people had real reservations about the sustainability of the financing. If we are talking about the mid eighties in particular or the early nineties, one of the other things you used to notice in those sorts of periods was the exchange rate going down. Another indicator of the suspicions that were held about Australia was the margin between Australian government borrowing in Australian dollars and US government borrowing in US dollars—in other words, the interest rate spread, and that used to blow out too. That was a sign of international suspicion about the credibility of our policies. We have not seen a glimmer of that over the last three years. Australian governments can borrow at almost the same terms in Australian dollars as the US government can borrow in US dollars. That is the sign that our policies are held in high regard. In Latin America, that is the variable they look at all the time; that is the variable that frightens them. The international indicator of whether world financial markets think you have a credible government with a credible set of economic policies is the interest rate you can borrow in compared to the interest rate that the US government can borrow in.

Mr LATHAM—Can I put to you one other and final possible explanation. The respected market economist, John Edwards, briefed this committee in the lead-up to the hearing. His opinion was fairly straightforward. He stated:

Australian foreign liabilities have more than doubled in the last decade and now weigh on the currency.

Traditional currency drivers have clearly been overshadowed by other factors, and growing foreign liabilities have weighed on market sentiment.

The former Treasurer, Mr Keating, made a similar observation last night. Is this something that the Reserve Bank concurs with?

Mr Macfarlane—I have never been convinced by arguments that we can use things that have been evolving for 20 years to explain what happened in a particular 10-month period this year. I have always been a bit dubious about those. Traditionally, people used to look at foreign debt to GDP ratio, which has not done very much at all. It has been relatively stable over the last decade or so. The difference in the interpretation you are referring to is that, instead of looking at foreign debt to GDP, they have looked at total liabilities to GDP. Total liabilities can go up—liabilities include equity, of course, as well as debt—because you are popular. That is what is happening in the US at the moment. Total liabilities to GDP in the US are rocketing up because everyone wants to buy US shares in US companies. The concept of relying on total liabilities to GDP as an indicator of the popularity or unpopularity of your currency is fraught with danger. I will not go into any more detail. I have read that stuff with interest, and I think John Edwards has got a few good points, but I do not think it is a satisfactory explanation of a movement in a currency that went as far as ours did in such a short time.

Dr SOUTHCOTT—In the conclusion of your speech to CEDA on 9 November this year you said that you had no intention of departing from your medium-term approach—that is, the inflation targeting approach—in an ad hoc attempt to push up the exchange rate for its own sake. What indications does the Reserve Bank have for foreign exchange market interventions? Are you able to tell the committee what the bank has been doing over the last six months in its foreign exchange market intervention?

Mr Macfarlane—That sentence in the CEDA speech was really about interest rates. There are two schools of thought. There is the school of thought which I referred to last time I was here as the Basil Fawlty school of thought: 'Don't mention the exchange rate'—like you should never mention the war. The first part of that sentence was to say: yes, the exchange rate is important. Along with all the other things that could cause inflation to go up, we take it into account. That is part of our medium-term approach. There is another school of thought which, fortunately, is not all that common here but I have seen it in other countries, where they say, 'Your exchange rate is going down; what are you going to do about it?' The implication is that you will just put up interest rates in an attempt to kick the exchange rate up.

I wanted to say in that sentence that we do have a consistent approach to monetary policy where the exchange rate does play a role. We are not going to depart from that just because this week the exchange rate looks a bit weaker than we would like it to be. We are not going to step aside and take a swing at the exchange rate and see whether we can kick it up. That would be very ad hoc, and it would be a very illogical and destabilising approach to monetary policy. That was what that sentence was meant to say. It was a very carefully written sentence to say, yes, we will do it in a medium-term sense, but we are not going to depart from our medium-term approach.

That is the answer to the first part of your question. The answer to the second part of your question on foreign exchange intervention is: yes, we do believe that foreign exchange intervention can be very useful and effective as long as it is done sparingly and you do not get overanxious. The evidence that we have not been overanxious this year is that we watched the currency come down from US65c at the start of the year, and the intervention we have done, which has been done relatively recently, was done only when it was below US55c, the low 50s.

Yes, we are prepared to come and intervene if we think a couple of conditions are met. If we think that the exchange rate has departed a long way from fundamentals—we are not the only ones who think that; there are a few other people around who have their reservations—and, secondly, if we think it is moving further away in thin trading conditions and likely to register another misleading observation in a destabilising direction, we will come in.

Dr SOUTHCOTT—On the same CEDA speech, in your comments about the attitudes of international investors, you touched on this issue of new economy versus old economy that is being widely debated. You raised, for example, the OECD report which shows just how wellranked Australia is in so many indications. I also took it from the speech that you were saying that the view of Australia as an old economy is one that people are actually acting on no matter how unfair it is. Is that the right implication to take?

Mr Macfarlane—Yes. I think there has been a tendency for people to make very quick, superficial judgments. One that irritates me somewhat is when people say that all the money is flowing into the US. You ask why, and they say it is because of the big productivity improvements in the US. You say, 'Hang on; our productivity improvements have actually been a bit faster,' and they say, 'I didn't know that.' I think they look for shorthand ways of making judgments. Regrettably, one of the shorthand ways, particularly in equity markets, is that they think you are a new economy if you have a well-known firm they have heard of. Finland is a new economy because it has Nokia, and Canada is a new economy because it has Nortel. We do not have a big, well-known institution that the equity funds managers have heard of. They do tend to make very quick and superficial judgments as to which are the new type economies and which are the old type economies. I think we have suffered unfairly because they have not made thorough assessments; they have made very quick, knee-jerk type assessments.

Mr SOMLYAY—I would like to follow up the point made by Mark Latham about perceptions. I do not want to upset our friends in the media here, but how much are overseas market perceptions influenced by bad journalism in Australia?

Mr Macfarlane—Do you want me to make a whole lot of enemies in the media? Sometimes it can happen. We have seen evidence occasionally where the Internet version of an Australian paper with a beat-up headline has had an impact in New York, but it is not common and it does not happen all that much. Of course, the quality of the media here varies enormously. There is some fantastic economic writing, and there is some very poor economic writing. It would be very dangerous to try to tar everyone with the same brush.

Mrs HULL—Governor, in the room today we have the economics classes and teachers from Trinity Senior High School and Wagga Wagga High School. The students of Trinity Senior High School have framed some questions for you which revolve around the Australian dollar. Does the Reserve Bank have a predetermined dangerously low limit for the Australian dollar? How low can we let the dollar fall? In follow-on, if it reaches a dangerously low level, what will the Reserve Bank or the federal government do to appreciate the dollar? Why didn't the demand for the Australian dollar during the Olympics lead to an increase in the value of the dollar?

Mr Macfarlane—That is the best question all day. I think I can answer the first one. You do not say, 'This is a level it is not allowed to go below.' Basically, the level of the Australian dollar does fit into a monetary policy framework in so far as it affects your forecast of inflation. The more it goes down, the more likely it is that the forecast of inflation will rise to a level which is unacceptable in terms of our medium-term target; therefore, in that sense, the more likely it is that we would respond with monetary policy, as I have explained on a number of occasions. But we do not sit there with a little level—we are waiting for it to hit.

As to why the Olympics have no effect on it, I think the answer is that the biggest single influence on the Australian dollar are big capital movements. They are not trade movements. We are told by the bureau that the receipt of foreign currency or purchases of Australian dollars that occurred during the Olympics was about $1.4 billion. In the grand sweep of things, that is actually not a huge amount of money. Over the course of a month, the exports and the imports, the capital inflow and the capital outflow and the investments and all the rest of it that will be going on would be much, much bigger than that. That $1.4 billion would be less than what was happening in a day. Even though it was a big event for us—it was a wonderful event and I suspect it will do us a lot of good in the long run judging from the number of people who speak to me about it whenever I am overseas; it will be very helpful in the long run—the amount of money that came in from television rights, tickets, airline tickets and hotels and things like that was not really massive in the overall scheme of things.

Proceedings suspended from 12.32 p.m. to 12.51 p.m.

CHAIR—Retail sales in October apparently fell by 0.2 per cent and building approvals for October went up six per cent. I understand that the predictions were that they were going to be flat. In the light of those figures, would you care to comment on how you see that in the current economic climate?

Mr Macfarlane—I think I will let someone with more intimate knowledge of these things comment. I will ask Mr Stevens to reply.

Mr Stevens—As you say, Mr Chairman, the figure for retail sales was down 0.2. I have not had a chance to examine that in detail. That was after a 0.8 rise last month. In trend terms it is going up gently. The building approvals rise of six per cent comes after a couple of months where it has basically been on the bottom. I would personally hazard a guess that that particular leading indicator and also the housing finance that we track have both reached their bottom at this stage.

CHAIR—Since we are in Wagga Wagga, I would be very interested to get your views, Mr Macfarlane, on the whole question of assessment of monetary policy and how it affects people in the regions and how you factor this in. By way of background, one of the points that I would like to make is that in the assessment of the CPI, the cost of living, the ABS measures only the six capital cities and, as I understand it, does not measure in any way CPI movements in the regions per se. While there may be practical reasons for this, it does appear a somewhat less than perfect way of assessing what is happening right across Australia. I was wondering if you would like to comment on how that might be distorting decision making and what ways it could be improved.

Mr Macfarlane—Your observation on the measurement of the CPI is correct, but I think it is an issue for the Australian Bureau of Statistics to address. It is six capital cities for the CPI index, is it?

Mr Stevens—I thought they had a slightly broader coverage than the six capital cities.

Dr Laker—It is eight capital cities.

Mr Macfarlane—I do not know the technical reasons why they have done it that way. It is a very expensive survey and they have to be very careful that they get a wide range of types of retailers and all the rest of it. I think you are right to say in principle that it should not just be capital cities; it should be non-capital city areas as well, and then there may well be a slightly different result. I would not be surprised if in the non-capital city areas inflation did not increase quite as fast as it did in the capital cities, but that is just hazarding a guess.

CHAIR—Would you like to expand on that point—do you expect it might be slightly less?

Mr Macfarlane—I do not think it would be a lot less, but I think prices of some of the very top of the range, high level, scarce, expensive things go up a bit faster than they do in more basic products. I think there is some evidence in some countries that consumer prices go up faster the wealthier you are; the more you are consuming more exotic things that may be trendy or in scarce supply the faster it goes up—but I would not want to put too much weight on that. It is possible that there is a difference on average between them. On the other hand, I think they do a pretty wide sampling within the capital city. It is not as though they just go to Double Bay or Toorak to do their sampling. I think they sample very widely through wherever the population is. If the majority of people live in the outer suburbs, they have most of their sample come from the other suburbs. I am not sure whether any differences or biases would be noticeable. In principle, I think you are right: there would be a case for going more widely, although it would probably be a lot more expensive. I think it is common in other countries that a lot of the CPIs are done in major cities.

CHAIR—So you are saying that the Reserve would not be reluctant to further explore that, but maybe we should take it up with the ABS?

Mr Macfarlane—Yes, you should take it up with the ABS. They may have a very good answer that I do not know about.

CHAIR—All right, we will take it up with the ABS.

Ms BURKE—What are the rural impacts of the Reserve Bank monetary policy on rural areas, given that regional areas had a greater proportion of debt in the population and therefore a one per cent rise in interest rates has a greater flow-on effect to the populace in a rural area? Do you have any comment on how monetary policy and the flow-on to interest rates can affect the regional areas?

Mr Macfarlane—I am not sure that rural households would have more debt that city households. I think the farm debt might be—

Ms BURKE—Yes, farm debt.

Mr Macfarlane—We do keep track of figures on farm debt. That is one of the things that we have followed. The problem there, of course, is that the big movements in farm debt are often caused by things over which we have no control, like the weather and all the rest. At the moment, we have just got the official figures, and we can look at those and quote those. But that is the sort of thing that we will be able to do in more detail once we get our regional economic intelligence network up and running. I am happy to talk about that if you want to ask any questions on that.

CHAIR—We do.

Mr LATHAM—I want to go back to the exchange rate. Mr Macfarlane, in an answer to Dr Southcott earlier, you said that the bank would intervene in currency markets if the Australian dollar moved away from the fundamentals; you said that you would come in with market intervention. Going by diagram 1 in your speech to CEDA, doesn't this mean the bank has now got a policy of ongoing currency market intervention, given that you have identified a 15 per cent gap between the predicted real trade-weighted exchange rate and the actual? It is so far away from the fundamentals you must be intervening on a consistent basis.

Mr Macfarlane—We have intervened in the last three months, and I think that is known. The crucial point of what I said there was: foreign exchange intervention is ineffective if you say, 'Here is a line, we are going to hold this line.' We know that. It is also ineffective if you jump in too early and you start intervening when there has only been a relatively modest deviation from where you thought it should be. I mention that as a way of saying that you have to be very sparing with your intervention, and we have been quite sparing with our intervention.

Mr LATHAM—You mentioned a three-month period, yet the semi-annual statement says:

In recent weeks, however, the Bank has entered the market on several occasions to support the exchange rate and reinforce the emerging tendency towards stability.

What has changed in the last couple of weeks that is different to the rest of that three-month period?

Mr Macfarlane—I am not saying anything has changed. I think there is a table at the back there that will tell you that in the months of September, October and November we intervened.

Mr LATHAM—There is a statement here though that says:

In recent weeks, however, the Bank has entered the market on several occasions.

Mr Macfarlane—I think that is part of a longer narrative that goes through episode by episode, and it is only referring to that particular period.

Mr LATHAM—With regard to the currency, 15 per cent is obviously a large margin. When will you be expecting some narrowing of that big gap?

Mr Macfarlane—I do not want to get into currency prediction mode at the moment, but I did say I thought there were some encouraging signs at the moment, particularly in the US. A lot of the story really emanates from the US. I think we are now starting to see some of the big players in the US thinking that the US dollar might have gone too far.

Mr LATHAM—Are you expecting an improvement in the value of our currency through to the new year?

Mr Macfarlane—I would think there is a reasonable chance of that happening, yes, indeed. I do not want to get drawn into the position of you asking me to give you a profile of what is going to happen to the exchange rate in the future, but I think the chances are quite good.

Mr LATHAM—Among media commentators looking at the exchange rate, there is an interesting concept known as ‘jawboning’, where there is an expectation the Reserve Bank will talk up the currency rather than talk it down. Does this strategy lose its impact, though, after a 12-month period where the currency has been consistently undervalued in your eyes? Can jawboning actually add to the perception that there is a problem here that is not correcting in the short term and that the bank is at a loss to know what to do?

Mr Macfarlane—I do not think you could say we have been doing jawboning. We have hardly said anything on the subject, apart from what we have to do in terms of reporting in our quarterly reports on the economy. The only major statement I have made was three weeks ago.

Mr LATHAM—Yes, and it is a major statement. The identification of that 15 per cent gap, I would have thought, was a pretty strong message to the market that the value of the dollar is lower than the fundamentals. I assume at every opportunity you point that out as you have today. Jawboning is a strategy that the bank uses.

Mr Macfarlane—It is something we have done, if you want to use that term. I do not really much like that term. You could say yes, that speech a month ago amounted to that and you could say some of my answers today amounted to that. It is not something we have done a lot of.

Mr LATHAM—On this question of market intervention, in the annual report there is a statement I did not quite understand, and I think I have seen it before, where you say that in April and May of this year, the bank ‘undertook some preparations for intervening’. What are the nature of preparations? Isn’t it that you intervene or you don’t?

Mr Macfarlane—You ask for some prices in the market. You did not actually do a transaction but you were seen to be there making some inquiries about prices.

Mr LATHAM—Does that have much of an impact?

Mr Macfarlane—It can.

Mr LATHAM—Did it in April and May?

Mr Macfarlane—If you look at June, it was a pretty good month. There was a period in the middle of the year where the currency went up for a while, it flattened off and then it came down again. There has almost been two phases of the fall in the currency.

Mr LATHAM—Finally, on a related matter, in the semi-annual statement you were talking about the impact of rising petrol prices and you say it is not as big as the OPEC 1 and OPEC 2 oil price shocks in the 1970s. But it is about half the impact in real prices. I was at high school in the 1970s and I cannot remember the exact details of that occasion, but historically this is quite a striking increase in petrol prices. Given that dimension, what will be the inflationary impact and where do you see petrol prices heading for the next couple of months?

Mr Macfarlane—Petrol prices is an interesting question. If you calculate the increase from the extremely temporary low point that preceded it, you can make the percentage increase look reasonably large, but you still cannot make it look anywhere near as large as OPEC 1 or OPEC 2. That period that preceded it, when the oil prices got down to about $10, was a very exceptional and temporary period. Over most of the 1990s, you would have to say that $20 was a realistic average for what oil prices were. They were $20, and they have gone up to $35. Sure, that has been inflationary and basically, in most countries, it has put about a percentage point onto their CPI. So it has had that effect.

As to the contractionary effects, we do not think they are going to be anything like they were on the previous two occasions, firstly, because the increase is so much smaller and, secondly, because a lot of these countries that are the beneficiaries of the increase in the price of oil go straight out and spend it now. The biggest single beneficiary has been Russia, and even Saudi Arabia is a country that runs a current account deficit. Saudi Arabia is a country that spends all its revcnue. It is not the same as it was last time when the big beneficiaries were desert sheikhdoms where they spend almost nothing and so they did not return the flow of demand back into the world economy. But if you look at some of the countries that are the beneficiaries now—Indonesia, Nigeria, Mexico, Venezuela and Russia—these countries receive the benefit of the higher oil prices and then they just go out and spend it on imports, so you are not having anywhere near the contractionary effect that we had last time.

Mr LATHAM—On the point about pricing, are you expecting that one per cent CPI increase to come off in the immediate period?

Mr Macfarlane—Yes. Even if you took a pessimistic scenario and said that the $35 is going to stay there, what that means is: last year we went from $20 to $35 and that added one per cent to the CPI and next year you would go from $35 to $35 which will add nothing to the CPI. You go from a year where oil added one per cent to a year where it added nothing. If, of course, the oil price goes down you will go from a year where the oil price has added a percentage point to a year where it actually subtracts from the CPI.

Mr LATHAM—What impact do you think this is having on our currency? Surely, if we are looking at a price change the equivalent of OPEC 2, then markets must be factoring in a slowing in industrial production. We are seen as a commodity currency; there must be some impact on our prospects in the medium to longer term if that transpires. Is this a factor in the low value of the Australian dollar?

Mr Macfarlane—No. Let us go back: I didn’t say it has been like OPEC 2; it has been very small compared to OPEC 2. And the price effects—

Mr LATHAM—It is the same real price effect; it really is. It is the same real price effect as OPEC 2 in 1970 prices. It clearly is.

Mr Stevens—Only if you go from the low point, though.

Mr LATHAM—Where do you go from? You do not go from the low point!

Mr Stevens—No, you go from the $20—you go from the average. I think you should go from where the prices have averaged for the past eight or 10 years, which is what you would have done in OPEC 2 or OPEC 1.

Mr LATHAM—From the low point it is the same impact as OPEC 2. The dip that you are referring to went over a three-year period and obviously had a substantial impact on Australian inflation, so it is having the impact in the opposite direction now.

Mr Stevens—It had some impact in pushing inflation down and it has been pushing it up lately.

Mr Macfarlane—But the more important thing is that the contractionary impact should be so much smaller this time than on previous occasions. On the previous occasions you were taking money off countries that spent it all and giving it to countries that did not spend it—that simply saved it. That is why you got this Keynesian contraction. It was like raising an indirect tax and not spending it. But this time the money will, by and large, be spent, and relatively quickly, because most of the countries that produce the oil spend it pretty well as fast as they receive it.

Mr LATHAM—Is that factored into market expectations, which is more important to our industry?

Mr Macfarlane—Yes. That is why people are much more relaxed this time than they have been on previous occasions.

CHAIR—Mr Latham was asking about the Australian dollar and so on. With the Reserve creating liquidity by selling Australian dollars under swap agreements, are you satisfied that such arrangements can safely continue without putting some downward pressure on the dollar?

Mr Macfarlane—We do not create liquidity. We prevent a contraction occurring. We stop the system seizing up through cash being taken out of the system—we put it back in. We are perfectly confident that that is utterly neutral.

Ms BURKE—In the CEDA speech you talked about the new and the old economy and you were talking about it before we broke off for lunch. Given that, as you say, much of this is about perception more than anything else, is Australia suffering because it has a perception it is not going down the track of the new economy?

Mr Macfarlane—Are we suffering?

Ms BURKE—Is the Australian dollar suffering?

Mr Macfarlane—I think I did say in the CEDA speech that I think that has been a factor, in that there have probably not been the equity inflows that there would have been and there has been a tendency for equity outflow into the US market. I also pointed out that a lot of that equity outflow, which was so keen to get the high rates of return in the US, actually lost money, as they bought very highly priced assets with very low yields and those assets have since gone down in price. If you talk to funds managers, there is no doubt that they were very enamoured of buying US assets.

Ms BURKE—If there is a perception around that Australia is not investing in new technology, does the Reserve Bank have a concern about our drop in spending on R&D and the long-term productivity measures, and outputs and growth in new industries in Australia in the long term?

Mr Macfarlane—I think the period of maximum discomfort for us has been during this period where there has been this almost uncritical worship of all-American, new technology stuff. That has been the period where it has been most difficult for us. I think that is coming to an end; more realistic assessments are emerging. On the issue of our long-term future—how much should we put into education; how much shall we put into R&D—I am enormously in favour of doing what we can there. There are a lot of things that can be done. Just grants for R&D may be one of the cruder things. There are much more deep-seated things that could be done, in terms of improving tertiary education and tertiary research and that sort of thing. We are all in favour of that. We all know that the returns to knowledge-intensive activities is much higher than the return to more traditional activities. We would all like to be closer to the frontier and it is a matter of working out what is the most effective way of doing it. It is a very long-term issue and the solution will be very long term. Rushing out and doing something, because someone told you that that is what caused the Australian dollar to go down, would be very misguided.

Ms BURKE—Isn't that one of the great problems we have—that everything is so short-termism nowadays; that we are not creating long-term responses to these things? We cannot overnight create a new-technology economy in Australia. It is going to be long-term, long hard yakka, government spend, incentives, and all the rest of it. Unless someone starts it, it is never going to take off.

Mr Macfarlane—I agree.

Mrs HULL—Following on from Mr Latham, I was going to ask you about the price of fuel and how it impacts on inflation, bearing in mind that we are in rural Australia and fuel prices are a major issue in rural Australia at this time. It seems that we have a vicious circle and there is already a premium in country pricing already. Is there a way in which we can differentiate the impact on country versus city, bearing in mind that on page 35 the report states:

Rural commodity prices rose by 4 per cent … over the September quarter and increased further in October.

The majority of production costs are associated and have a lot of fuel costs associated with them. It appears to me that there has to be some rebound—some impact of the cost of fuel—on production, particularly in commodity production or in getting that export value ready. How would it impact overall on inflation, as well?

Mr Macfarlane—I am afraid I cannot help you very much there. You are really asking a question about tax policy, or something like that. I can record what has happened to fuel prices; I can record what it has done to inflation. But you are asking me to make a comment on some sort of a distributional impact between one region and another, and that is really not for a central bank to make a decision on a thing like that. It is (a) a political issue and (b) a fiscal and taxation issue.

Mrs HULL—With the cost of fuel being so high, and we are looking to export more and our market is geared towards a very substantial increase in exports, could the cost of fuel impact on that overall future market?

Mr Macfarlane—It could at the margin, but my guess is that the rise in commodity prices and the fall in the exchange rate would have given a much bigger windfall to an exporter than the increase in fuel costs would have been a disadvantage.

CHAIR—I would like to move on to the subject of the planned closure of five of your seven state branches and how you propose to counter the perception that that may mean that you are a little bit too focused on one or two areas of Australia and not as mindful of what is going on in other areas.

Mr Macfarlane—This is something that I explained to the committee at the last meeting. My understanding was that the committee fully accepted the explanations for why those by then very small branches had to close. They were not serving the public; they were serving government departments and state governments, and they did not want our services any more so the branches had to close. We are talking about Hobart, Perth and Brisbane. Adelaide is still operating because the South Australian government does its banking business through us. We were going to close the Melbourne branch although we still have a significant operation in Melbourne through both Note Printing Australia and through our national note distribution centre.

Nevertheless, there were a number of states which would be without representation if we had done nothing about it. We decided that we should do something and we think we are putting in place something which will be much better than the old system. The old system was not essentially an economic intelligence gathering branch; it was basically bankers who were handling bank accounts and they reported back to the banking part of the Reserve Bank. What we are now going to put in place is to open offices in Perth, Brisbane and Melbourne. The Melbourne one will also serve Tasmania. The Adelaide one will continue.

We have already made the appointments and we have already got the premises and we will be up and running in January. These offices will consist of two professionals: the chief representative plus an economist who is assisting them, plus a back office. The important thing this time is that those people who are in the states will not be reporting to the banking department any more; they will be reporting directly to Glenn. In fact, not only will they be reporting directly to him; they will be part of his department. So our economic department will now have positions in Perth, Melbourne, Brisbane and Adelaide. Because of the wonders of modern technology, they will be fully-fledged members of the department; they will have access to all the information that people in Sydney have. They will be coming to Sydney regularly. People from his department will be going to the capitals.

It is understood in each of these offices that they will not just be remaining in the capitals but will have a program of visits to regions within their state. They will be feeding information directly to Glenn's department, which will be part of our assessment of how the economy is going and part of our forecast of how the economy is going to go in future. We think that when this system is fully operational, which will be in the first few months of next year, we will be in a much better position to receive information from other states and regions than we have ever been in.

CHAIR—That assurance that they will be moving out of the cities is well taken.

Mr Macfarlane—I have no doubt that they will be keen to move out of the city. They will be able to do the job so much better and it will make the job so much more interesting.

Dr SOUTHCOTT—I want to ask you a question about the section ‘International and Foreign Exchange Markets’ on page 12 of the semi-annual statement. From a period in the second half of 1999 it looks like the tightening in interest rates has been a quarter or half a per cent in all the countries that we are looking at—UK, US, Canada, the European central bank. We know that previously there was coordination between the central banks in terms of reducing interest rates, in 1987 for example, and also in 1997 during the Asian financial crisis. I wonder to what degree there is coordination between other central banks.

Mr Macfarlane—We talk to each other a lot but there is not ever any formal coordination. I never know, and I would not ask, whether any of the other central banks are planning to raise interest rates. I know when they have their meeting, but I would not presume to phone up and say, ‘What are you going to do?’, and they would not presume to phone me and say, ‘What are you going to do?’ We keep very much in touch with each other but there is no plan. To the extent that there are similarities it is because, firstly, the world economy has certain regularities that we all respond to. I suppose the second thing is that maybe we think alike because we speak to each other so much. But we do not have a coordinated plan.

Dr SOUTHCOTT—Is that different from the examples in 1987 and 1997? They were not coordinated either?

Mr Macfarlane—No.

Ms BURKE—I am quite surprised we have got Mr Macfarlane on one of these hearings and we have not talked about wages. I think I should break the drought. I would like to start with GST impacts on different income cohorts. What implication does this carry for a wages response to the introduction of the GST? Have you done any distributional analysis of it? In the monetary statement you note that the ACTU has a wage claim in at the moment and that some EBs have GST expectation clauses in case there were greater CPI or GST hikes, but you do not actually draw any conclusions or make any analysis of it. You state a fact but you do not give me any answer about what you think the impact is. Have you done any analysis? If not, why not, given that presumably a core concern for the bank is possible inflation in the near future?

Mr Macfarlane—I will attempt to answer it but I am not sure whether I know enough to give a complete answer. We are still working on the assumption that the reductions in taxes and the increase in welfare benefits offset the rise in the GST for all groups in the community. Given that is the case, I think in the wage bargaining process it is very difficult for the unions, for example, to argue that they need an additional increase in wages to compensate for the GST. In fact, we refer to that as ‘double compensation’.

The other thing that has come along which has made this even a more comfortable situation to handle is that it does appear that the first round effects, certainly, of the GST have been lower than all the widespread forecasts indicated. So those wage contracts that said they could be renegotiated if there were a higher than expected GST effect presumably will not be able to be renegotiated because there is general agreement that the GST effect was lower than expected.

Ms BURKE—So you do not share the view that the lower income earners at the other end of the scale who have got a lesser tax cut have actually not benefited from the tax cuts and the increases to allowances and such?

Mr Macfarlane—I cannot see how that could have happened. It is really the other end, at the upper end of the scale, where there is a maximum dollar amount you might be able to claim. But at the lower end of the scale I do not think you can make the claim.

Mr Stevens—We have not done detailed cohort analysis. The government did that when the package was put together. We do not really have the resources to add any value there so we have not done that kind of distribution work.

Ms BURKE—Therefore, given that and your opening statement that you think wages are more or less benign, you have no concern about upcoming wage case claims and an impact of inflation?

Mr Stevens—As Ian said, we have been assuming all along that the GST would not find a secondary echo in wages. To continually assess whether that was a reasonable assumption, we try to monitor how many enterprise bargains have clauses in them, and there are some. That has increased a little bit but, as far as we can tell, there are not that many. In the ones where we knew a little bit about the nature of the clause, you had to get a pretty big CPI effect to trigger it, which we have not had. I personally am just as comfortable as I ever was about making an assumption and probably more so, in fact, at the moment. It is still early days but I think the assumption we have been operating on—that there are no secondary impacts of the GST per se—is still a reasonable one.

Ms BURKE—For the first time that I have noticed, you have made a reference to executive salaries in your November monetary statement.

Mr Stevens—It is in there every time.

Ms BURKE—Is it? I am sorry, my apologies. As I say, it seemed to me—

Mr Stevens—It has been in there, I think, every time for some years.

Ms BURKE—Given that you state you are relying upon one analysis that it is only up by four per cent, do you have concern with executive salaries? Given our discussions earlier about surveys and their reliability, do you think the survey quoted about executive salaries is a reliable one?

Mr Stevens—To my knowledge, it is the only source of systematic data on this, so we use it. I am not aware of other sources which offer the same degree of comprehensiveness. There are newspaper headlines and so on but they are typically rather small and quite selective samples. To my knowledge, this Mercer Cullen Egan Dell one is the only one that is around of reasonable quality, so that is what we use.

Ms BURKE—Are you concerned about executive salaries and the increases to bonus and share schemes and all the rest of it?

Mr Macfarlane—I think I have been asked this one before. I would say that I am certainly puzzled by it. I am prepared to work very hard for a lot less money than that, and so I can’t understand why people need such massive millions of dollars in salaries. As I said, it is almost like a winner-takes-all market: it is like entertainers and sports people where a very small number at the very top get unbelievably large remuneration. I don’t fully understand how that market works.

Mr LATHAM—I would like to follow up on one matter. What weight do you give to the possibility that the GST price impacts are somewhat delayed and that one CPI number does not tell the story?

Mr Macfarlane—In all our written stuff we have said there are three possible explanations for the fact that the September quarter figure was lower than we thought. I think I mentioned them earlier: the initial forecast was wrong; the wholesale price decreases came in much more quickly than we thought; or the price increases did not come in as quickly as they should and they will came along in a delayed fashion. There is probably some element of truth in all three of those. It does not have to be one of the three and not the others. There is probably some element of truth in those. I would be surprised if the factor you are talking about is going to be a major influence. I would be surprised if there were a lot of people who did not do it and then they all did it. I think there may be some people who will take opportunities to make up for what they failed to do before, but I do not think it is going to be a big factor, although it may be. We will just have to watch it closely as the figures come in.

Mr LATHAM—In a competitive retail market, it looks like the wholesale tax abolition was passed on pretty quickly. Is it most likely the forecasts were wrong?

Mr Macfarlane—I do not know. I did not make the forecasts and I do not know the details of them.

Mr LATHAM—It is easy then to give an independent comment on them!

Mr Stevens—It is too soon to know and I do not think we ever will know for certain. As the future CPIs come in, we will narrow down the range of uncertainty to some extent. As far as the original forecasts go, those forecasts were asked to do something quite difficult, which is to take a large set of big relative price changes and weight them together and come up with an aggregate outcome. They always should have been seen as having a degree of error margin around them, as all forecasts do.

Mr LATHAM—On another piece of speculation, labour productivity rates, there are a number of people, some of them in prominent government positions, who seen to point to a long-term step-up in Australia’s productivity rate—new economy effects, the success of micro reform from the 1980s and early 1990s—and suggest that this step-up has somewhat increased the sustainable growth rate in the Australian economy. Is this something that the bank adheres to? If you do, how do you then explain what seemed to be a surprising drop in labour productivity as identified at page 30 of your statement?

Mr Macfarlane—Yes, Australian productivity, whether it is labour productivity or multifactor productivity, certainly has picked up in the 1990s and it has done very well. It has actually risen faster than the US productivity has risen. That is not to say that our level is as high as theirs but it has risen faster so we are slightly catching up. That part is true. To the extent that that is happening, it does contribute to a higher potential growth rate. On the other hand, our labour force is not growing anywhere near as fast as it was a decade ago—which has the opposite effect.

If you put the two together, they do not exactly cancel out. We think that the increase in productivity is slightly more important than the reduction in the rate of growth of the labour force, so there is some evidence to suggest that the potential growth rate may be a little higher than earlier estimates. That is the answer to your first point. Given that that is happening, we believe the way we conduct monetary policy allows that to come through. If the economy does want to grow faster in potential terms, it will come through.

Your final point was: why did labour productivity slow down last year? The answer to that simply is that it is just lumpy—that these things go in fits and starts—isn’t it, Glenn?

Mr Stevens—Yes. The interpretation I would offer, at present anyway, is that we had a period where output growth ran ahead of employment and then we have subsequently had a period where the employment had to catch up, if you like, and you need an unusually quick period of employment growth to do that. If that interpretation is correct, then we will see the earlier, somewhat stronger trend in productivity growth reassert itself over the coming couple of years. That would be my guess.

Mr LATHAM—So the jury is out to that extent?

Mr Stevens—Yes, you can never be positive about these things. There are mini cycles, if you like, in productivity growth, which is why we always take a long period and figure out the average over a long period before we make any strong statements about it. I personally would be very wary of trying to make strong statements about short-term productivity movements.

Mr LATHAM—Someone who seems to have a pretty fixed view on this is one of your board members, Ted Evans. In May, he said that as we get closer to full capacity it is appropriate that we should attempt to grow at a capacity growth rate—that is, 3½ to four per cent—so as to keep inflationary pressures subdued. That has been the touchstone of macro policy decisions—not just fiscal, but macro across the board. It seems to be a wonderful formula: full capacity, capacity growth rate of 3½ to four per cent and we are keeping inflationary pressures subdued at the same time. Is it one that the bank supports?

Mr Macfarlane—Our view is that if you conduct a monetary policy according to the inflation targeting method correctly, and if it turns out that the economy wants to grow faster than you previously thought it could, that faster growth will come through, because you only tighten monetary policy when you are reasonably confident that your forecasts are showing that if you do not inflation is going to exceed your preferred path. If it turns out that the economy is growing faster than it used to but there still are not inflationary pressures coming through, you do not tighten. In that sense, we have had an experience which is somewhat similar to the US.

I used to get the question posed to me quite often in 1996 or 1997 when I first got the job: people were saying, ‘The Reserve Bank will not let the Australian economy grow faster than 3½ per cent. They’ve determined that that is its potential growth rate and anything above that will be inflationary. They will not let the economy grow faster than 3½ per cent.’ I used to say, ‘That’s not true,’ and I would give the same answer I just gave to Mr Latham. The evidence that I was speaking the truth is the fact that the economy has grown. It has averaged 4½ per cent for the last three years and it is only in the last bit of that period that we were tightening. But during 1998 and 1999 the economy was growing at 4 ½ per cent and we were not tightening. My ultimate answer on what is the potential growth rate of the economy is, firstly, that I do not exactly know. I suspect it is a little higher than it used to be, but I do not exactly know. But I do not have to know in advance what it is. If you conduct monetary policy properly, it will emerge.

Mr LATHAM—One of your board members has said 3½ to four per cent. Is that a view that the rest of the bank shares? You have a board member out there saying it; it is a valid question to know what everyone else thinks.

Mr Macfarlane—I do not know that I can comment. I think you ought to ask Mr Evans.

Mr LATHAM—I never get to see him. Where is he? Bring him along one day.

CHAIR—In cheque clearing cycles you still have a couple of slow movers. What is the progress there?

Dr Laker—Broadly speaking, there has been good progress. In the annual report of the Payments System Board we listed 26 banks who now provide the three-day cheque clearing for cheques that are presented electronically, which has become an industry standard. The industry itself determine the standard of three days and we have supported it. A couple of major banks still are not in that list and there are some banks that are going to be moving across in the next year or so to join that list. The majors that are not there have some serious technology issues which they are looking at. These are major technology challenges to take advantage of the newer procedures. We talk to them, but we are aware that that is what they are facing. Those that are on the list account now for over half of the cheque clearing industry, so there is plenty of choice for consumers who are not getting that service but who want that service.

Ms BURKE—The ACCC is not currently on the Payments System Board. Given their involvement with the payment system, do you think they should be?

Mr Macfarlane—No, because the ACCC has a job to enforce and interpret the Trade Practices Act across all industries. They are not a body which is a specialist on the payments system, so there is no reason for them to be on the board. On the other hand, it is very important that we have close cooperation with them, and we do.

Dr Laker—We actually have a memorandum of understanding with the ACCC, because our legislative responsibilities have quite a lot in common.

CHAIR—I think we might move onto the report that you were waving around in your opening statement, Mr Macfarlane. On the question of interchange fees, you identified that customers in Australia are often being charged more than in other countries and those conclusions were pretty clear. But what about recommendations as to where to go from here?

Mr Macfarlane—The main action will be on credit cards. This report covers three different aspects of cards. It covers ATMs, debit or EFTPOS cards, and credit cards. The biggest chapter here is on credit cards because, to some extent, that is the biggest issue. On credit cards, there is a process that is already occurring, through the ACCC. The ACCC received a complaint from a retailer or someone who said that this retailer was being disadvantaged because the banks, through the credit card scheme—Visa, Mastercard and Bankcard—were collectively setting an interchange fee and this interchange fee was being passed through into the merchant service fee. In other words, when the retailer spoke to their bank about putting in place a credit card operation in this retailer’s shop, the fees were too high and they were too high because they were underpinned by this interchange fee.

Because of that complaint, the ACCC had to hear that, and the ACCC did. They concluded that what they were looking at was a per se case of price fixing. There are two solutions that can happen when the ACCC finds that. The first is that the parties concerned could dispute it: they could go to court and say, ‘No, it is not price fixing.’ Or, the other path, which has been widely used, is for the parties to go down a path which is called authorisation, which says, ‘Yes, it is price fixing, but it is the only practical way of doing this thing and, if we make a few modifications to it, it will be in the national interest.’

So the ACCC is attempting to get the banks to go down this path of authorisation, and I gather quite a number of the banks are happy to do that. One or two are not; certainly one is not. So we have not yet determined which of those two paths will be followed. We would see it as being very sensible. In fact, the only logical conclusion for the banks is that they should go down the path of authorisation. If they go down that path and they make various concessions and come back with a new way of doing these things that the ACCC judges to be in the national interest, then that particular one of the three card schemes would have been resolved.

If they do not, if they want to play hard ball and go down the court legal challenge path, we have been told that this could be extremely time consuming, that it could take years, and I am not sure we think that that would really be in the national interest. We think that would probably be very unhelpful to the national interest. If we thought that that was the most likely outcome, we would have to go back to the Payments System Board and consider whether we would be prepared to let that happen. If not, we could use the powers of the Payments System Board to do what is called ‘designate’ that particular credit card payment system. If we do that, the Payments System Board has the power to step in and set standards in pricing and access. Either way, I do not see the status quo on credit cards continuing, and I think it is up to the banks to decide which of the paths they want to go down.

CHAIR—In your report you talk about, for example, credit card issuers having a mark-up of over 39 per cent. After paying interchange fees to issuers, credit card acquirers have a mark-up over costs of around 67 per cent. Obviously, it is quite an attractive little money earner. What sorts of reductions do you think should be reasonably expected and, given you have got those powers one way or another, should be extracted?

Mr Macfarlane—If we are talking here only of credit cards, there is a big difference between credit cards and the other two. Credit cards are the ones where the ACCC has said that price fixing is occurring, because there is the one price for all the financial institutions that are involved in the Visa, Mastercard and Bankcard scheme. For the other two, which are the ATMs and the EFTPOS, there is no such get together; it is actually a whole framework of bilateral agreements, and so that is an area where I think the ACCC is unlikely to be involved. I think those two are areas where we would probably be the ones who would take the front running.

I don’t think, at this stage, it will be a matter of us stepping in and saying, ‘You shall pay such and such a price.’ We are not the Prices Surveillance Authority and we are not the price setters. I think what we would be looking for is for them to come to a system which was transparent so people would see what was going on and see what other people were being charged. Secondly, we would like to see a system where the consumer actually has some influence and where the consumer, the cardholder, can use the card— or in the case of the ATM use the ATM—that charges the lowest price. We would like to set in train a whole lot of standards that would involve transparency, probably setting prices regularly year by year. One of the problems here is that these prices were set a long time ago and the technology which underlies them has improved so enormously that the unit costs must have been coming down and yet the prices stayed where they were. We would want to see some system whereby prices would be reset according to some methodology which was satisfactory to us.

Dr Laker—In the case of the negotiations and discussions under way between the card scheme members and the ACCC, one of the major issues is the methodology for setting the interchange fee. As far as we understand it, there is no regular methodology used by the card scheme members in Australia. We have the sense that the current fees were handed down on stone tablets to the current generation and there was no way of getting a sense of how these fees were determined. What the ACCC are looking for, and we support them in this, is a transparent, cost based methodology, so that we could see how these interchange fees were being set, and an assurance that these fees were being set to reflect the costs that they are meant to recover. Transparency, an objective and acceptable methodology, is quite important to the ACCC’s dealings and it is also something which we support as well.

In the study, one thing we did do was to try to work out what the fee structure would look like if you applied the sorts of methodologies which are used overseas. On that basis we could not understand why the interchange fees were set at the current level. The industry and the ACCC are now trying to work their way towards a set of rules acceptable to all sides, to put this on a transparent and objective basis.

Mr Macfarlane—The main thing we have done to date is just to do this study, which was an enormous amount of work. It was about 18 months work to do this, and it is probably the best study of its kind anywhere in the world. The reason it is the best is that the powers of the Payments System Board meant that we could get data and costings from the banks which were not available in other countries. At this stage, most of our intellectual effort has been going into getting the study completed, getting it into the public arena and waiting for responses from the affected parties. The affected parties are, of course, not just banks but retailers, utilities, other billers and consumers. We are waiting for that. So at this stage it is probably very difficult to respond and say: this is exactly what our game plan is; this is what we have got planned out. We do not really have a firm set of plans. We have to wait and see when we get all the responses in.

Ms BURKE—So you are not going with the ACCC's strategy of authorisation of interchange payment systems under the Trade Practices Act by 21 January 2001?

Mr Macfarlane—We have accepted that on one of the three schemes—the one where there is already a process under way, which is the credit card scheme involving the ACCC. We are supporting the ACCC, and we hope to see the banks and the card schemes go down the authorisation route.

Ms BURKE—If we look at the ATM and EFTPOS, does the Payments System Board believe that the fees are currently efficient? Is there a need to examine these payment systems more thoroughly?

Mr Macfarlane—The answer to the first is no, and the answer to the second is yes.

Ms BURKE—Does the Payments System Board have any comment following today's article in the *Financial Review* on Westpac lobbying to change fee structures for ATMs? Does the Payments System Board have any comment on the current structure of interchange fees for ATMs, in particular for foreign ATMs?

Mr Macfarlane—John, I have not read the article referred to, so I will let you answer that.

Ms BURKE—My apologies. It is today's *Financial Review.*

Mr Macfarlane—I have seen the article in more than just one paper.

Dr Laker—The board, in its annual report this year, went over the study and made the statement that, in our view and on the basis of the costs statement that was provided to the study, there was ample scope to bring down the fees that a consumer pays if he uses the ATM of another financial institution. How that is done is a matter we raised because there are several options. One is that the bilateral interchange fees could be renegotiated. There does not seem to be a lot of competitive pressure to encourage or force the major participants to do that. The other option that we flagged is the direct charging idea, where the consumer will see a price on the ATM machine saying: if you use this machine it will cost you X. We raised that option because it is an option used overseas, and it is also one which brings the consumer into a direct relationship with the supplier of the ATM service.

The initial feedback we have had from some of the members of the industry—which is, in effect, reflected in today's article—is that they can see merit in that idea. Bilateral negotiations and bilateral arrangements are by their nature very sticky. If you want to change them, somebody has to win and somebody has to lose, and that biases you towards leaving them untouched. We had a sense that the industry acknowledges that those arrangements were ripe for review. We put the spotlight on them and some of the key participants in the industry have looked at them and said, 'Yes, these really do need to be looked at.' Westpac is signalling that it wants to review and have a look at alternative arrangements. We have said that we would be happy to be an honest broker in the process of bringing people together to look at these options, and we will talk to the participants all the way through this process. We want to see a sensible response, and we want to see one fairly soon.

Mr LATHAM—If it gets bogged down or there is some legal process, are you willing to designate the direct charge regime for ATM fees?

Mr Macfarlane—As I understand it, the only area where it could get bogged down legally is credit cards. I have already said that, yes. If we thought that was going to happen, we would designate it.

Mr LATHAM—But on ATMs, Dr Laker said it can get sticky, and sticky often means time consuming.

Ms BURKE—And expensive.

Mr LATHAM—Are you willing to designate? I congratulate you on the report. There is a lot of bank bashing rhetoric in Australian politics. This is the report that gets the facts straight, and it is a damning critique of the banks. I calculated 175 per cent mark-up margins on ATM fees. That is absolutely outrageous. These people are not using their market power properly. They are using it to exploit customers. Surely something has to be done. I congratulate the bank on the report. But I would like to see a commitment to being willing to designate the direct charge regime if all else fails.

Dr Laker—Rather than designate a particular solution, what I would say is that our powers follow the consultative process. That is what we are given a mandate to do: to use the powers after we have been unable to get cooperation and more efficient arrangements without those powers. We are in that process now. We have done the study, we have put it on the table and we have said to the industry that the current arrangements are not efficient. We want a response from the industry and we will work with them, taking into account the views not just of the financial participants but of the users, retailers or people affected by these various card schemes.

If the cooperative route is not effective, then we have the powers available to us. I would not like to speculate on how we would want to use the powers, but we would have the same types of powers in the debit card schemes as we would have in the credit card schemes. We would designate it and then we would set some standard for transparency of pricing and for the pricing of these sorts of arrangements to be cost based, to be reflective of the cost that the card service providers are incurring. Those are the broad approaches. I would not like to speculate on how we would prescribe a specific solution, but we know what we would be looking for generally.

Mrs HULL—It is just as well the high school framed several questions on the Australian dollar. I would like to frame several questions on bank fees and charges. Governor, you have often stated that inefficiency in the retail payment system and bank fees are major issues with the general public, in particular with small business. ASIC appears to have responsibility for policy issues on bank fees related to conduct and disclosure but not for the level of bank fees and charges. ACCC says it is powerless to act on the quantum of fees. Who is actually responsible for that? Does the Reserve Bank consider it has a responsibility for overseeing the level of bank fees?

Mr Macfarlane—No, we do not have responsibility for overseeing the level of bank fees; we have responsibility for the payment system. Some of the activities that the banks do are specifically related to the payment system—interchange fees for credit cards and debit cards are, so we have the power to be involved there. For the general level of fees—for example, an establishment fee for a loan—we certainly do not have any powers at all.

We have done some work for this committee on just measuring fees. If you remember, a long time ago this committee asked us to do some work on margins—which we thought came within our area of speciality because it was relevant to monetary policy at the time—and we were able to demonstrate that margins had gone down. Then the question arose: if margins have gone down, has that all been offset by fees going up? So we did another study, and we established that it had not been offset by fees going up and that most customers had done better out of the fall in margins, even though some of that had been offset by a rise in fees.

We have not gone any further than that because we really do not have any responsibilities in that area, and I am not sure exactly who does. If a lot of people decided that the loan establishment fees were too high, I am not quite sure what would follow from that. We are assuming that competition would mean that if one bank's were too high some other bank would offer something lower. Certainly, there is some evidence in parts of banking of where there is very strong competition of that nature. I do not think there is anybody that has got the power to say, 'We just don't like bank fees being too high. We order you to put them down.' I do not think there is anyone who has that power.

Mrs HULL—Far be it from me to suggest that there is collusion among banks on bank fees. But if there were, who would be responsible?

Mr Macfarlane—The ACCC.

Mrs HULL—Yet there seems to be some sort of fuzzy area—they are not really concerned about it, or they do not really think they should go in on this. That was the main basis of my question. At the May 2000 hearing, you reported that customers without a loan and those with small balances and high levels of transactions would not have benefited from the trends in fees and charges. The committee then expressed considerable concern on the matter. Could you tell me if anything has changed in this area during these past six months?

Mr Macfarlane—I do not know that much has changed other than that there are a considerable number of people who have a fair number of transactions and low balances who do not pay any fees at all. There are a lot of pensioners who pay no fees at all; there are a lot of students who pay no fees at all. I think the banks have made some reasonably generous gestures towards those people, who really have got very little money. When we wrote that, we were saying: if you have got a loan, you have definitely benefited from the reduction in margins. You may have given some of that back because you are now being charged fees for things that, formerly, fees were not charged for. If you are somebody who has not got a loan and you are now paying fees for things that you previously got for free, yes, it does cost you more. I do not think it is correct to then say that they should not have charged you fees.

The logic of the banks moving towards fee for service is that, if they did not move towards fee for service and relied instead on the fat margin, which is what they used to do, they would eventually lose their business because other banks would come in and take the profitable customers away and they would get left with the customers who have lots of transactions and low balances and who are actually very costly to maintain. I do not think we can object in principle to the fact that banks have fees for particular services. I do not think anyone has the power or could make an economic case to roll back to where we used to be.

Ms BURKE—So you would argue that banks do not have any social obligation in respect of—

Mr Macfarlane—No. I have already said they have done some things there. They have fee-free accounts for students and pensioners.

Mr LATHAM—Central bank independence is a policy issue that the committee has monitored in the past. I want to follow up on a few issues from previous hearings and check out subsequent events and bank performance. At the May hearing in Melbourne, the committee raised the issue of whether Australia was the only country in the OECD in which a Treasury official sat on a policy making central bank board. At that time, the governor was going to get us some clarification about that. What is the situation?

Mr Macfarlane—I think that is correct.

Mr LATHAM—Again, in May, the semi-annual statement on monetary policy noted, in a discussion about the Australian dollar, a view—developed and encouraged by some softer economic data in Australia—and some political comments about interest rates, and it went on to talk about a decline in the value of the currency. I noticed that, at box (b), page 13 of this hearing's statement, all mention of political comment has been erased. Is there an explanation for that, given that what happened seemed to be pretty firmly on the public record?

Mr Macfarlane—I do not think it was a particularly important part of that episode. If we really have to go over the old coals, some statements were made—statements that did not trouble me at all—on the Thursday. There were then two sets of very powerful economic statistics that came out on the Friday: a much lower than expected CPI for Australia and a much stronger than expected GDP for the US. On the Friday, when those two sets of statistics came out, the Australian dollar fell very sharply. Various interpretations were put forward as to why, some of which relied only on the two events that occurred on the Friday and some of which also made reference to the statements that were made on the Thursday. No-one will ever know what the outcome was. However, in later months, similar statements were made by the Prime Minister, which I said at the time he had every right to make, and they had no impact on the Australian dollar. The later episode, where those statements had no impact, tended to diminish an argument that the earlier episode was caused by such statements.

Mr LATHAM—So this is like a real economy assessment of what happened as opposed to media and political events?

Mr Macfarlane—Even in the first event, we only ever said it was a misinterpretation by the market of political statements. The statements are common in a lot of countries. You often find

Prime Ministers, finance ministers and treasurers—although you do not find it here—saying that they do not like the idea of interest rates going up or that there is no need for interest rates to go up. It is quite common.

Mr LATHAM—It is a sign of independence, isn't it?

Mr Macfarlane—That was the argument we made last time. It would not happen if the government were making the monetary policy; they would not criticise their own monetary policy.

Mr LATHAM—I noticed in that fine journal, the *Financial Review*, an editorial on 5 October. It is particularly good on a Monday; that is true. There was a view expressed that the RBA silence is unreasonable given the amount of media and sometimes market speculation regarding board meetings and that, where there is no policy change, the bank should issue a statement on why a decision was taken to make no change. Do you think that would be a useful process in building market and public understanding of policy making and board decisions?

Mr Macfarlane—No, I do not. You could make the case that it was a good idea, but I do not think it is. We already put out the most detailed account of any central bank when we do make a change. We put much more into it than anyone else does because we have got something pretty constructive to say. If every time we did not make a change, we had to say something, it would be a real burden to try to find 50 different ways of saying, 'Nothing has changed; therefore we are not changing.'

Mr LATHAM—What about in circumstances where the fundamentals are changing, so a decision not to change policy would actually have an impact on monetary conditions? Do you think it would then be reasonable to expect a statement from the bank?

Mr Macfarlane—No. It is not coincidental that the call for this statement came from a newspaper. Basically, the calls for more and more statements from us always come from people who have a vested interest in making that call; it is their job to write these things up. It could be useful at the margin, but I very much doubt it. I think you would have just as much chance of destabilising the market as improving its education.

Mr LATHAM—On another matter of transparency and communication, Mr Macfarlane, you have expressed a view in the past that it was not necessary for the bank to release minutes of board meetings, as is often the practice overseas. Again, in the *Financial Review*—of 4 August on page 1—a report gives a blow-by-blow account of action, decision making and voting at a board meeting. The first paragraph—and it goes on for many—reads:

> At least two Reserve Bank of Australia directors objected to Wednesday's 25 basis point rate rise, with the latest pre-emptive strike at inflation sparking one of the bank's most vigorous boardroom debates.

It continues:

> An RBA spokesperson declined to comment last night when told *The Australian Financial Review* intended to report that at least two directors opposed the decision.

That is the equivalent of publishing minutes. Wouldn't it be better for the bank to cut out the middle man and get a reliable account out there for markets? While newspapers can be dismissed at one level, people do read them. This is an account where, undoubtedly, the official version of minutes would be much more reliable, particularly in terms of credibility.

Mr Macfarlane—You are assuming that the account in the newspaper you refer to is correct.

Mr LATHAM—It was not corrected by your spokesperson. Your spokesperson declined to comment, which in my vocation normally means that it is not far from truth.

Mr Macfarlane—Not in ours.

Mr LATHAM—Okay.

Mr Macfarlane—There is an ongoing discussion about the release of minutes. I have never said that we would die in a ditch to prevent them coming out. My feeling is that there may be some advantages. I have not heard a very strong case for the minutes. A lot of this debate is carried out on the assumption that in a perfect world every member of the market would know all the time what was going to happen. There would never be differences of view: you would not have some people expecting rates to go up and others expecting them to stay steady. If there were any of this uncertainty remaining—'This is bad and it means that markets are not going to operate very well, so you should do something about it to make sure this does not happen.' I am not sure that that is the ideal way for a market to operate. Even then, if we did put something out, they would still would have to wait another month before something else came out. So they would be able to get upset and be confused in that period between one month and the next month. Then you would get cries saying, 'You ought to put something out more often. You ought to keep us updated more often.'

I find in the countries, particularly in the US, which has had the longest tradition of putting minutes out, that when the minutes go out they do not really have much of an influence at all on the public debate. They get referred to, but not much. You do not see a big jump or a big change in financial prices because the minutes of the last meeting were released. They may have some benefit for academics. They certainly give some people something to write about, but I am not sure that there would be a huge amount of value.

The other thing you have to remember is that the stuff that we do put out when we change policy is very important information. That is real time information. We have to write it and put it on the line. We have no idea at that stage when we have written it and released it how the market is going to react, how the press is going to react, how the public is going to react or how the politicians are going to react. We have to give our pure, honest thoughts. The problem with minutes is the very nature of minutes. You have the meeting and someone has the job of writing up the minutes. They cannot write everything that happened. They have got to try to work out what they think is important and what is not. Then they have to distribute that to the members of the board, who have to have an opportunity to say, 'No, you've got that wrong,' or 'No, we spent more time on this,' and then they have to come back with their comments. There are going to be conflicts there—someone says one thing, someone says the opposite—and you have to go through a negotiating procedure to try to sort that out. Then you have to send out another set of minutes and say, ‘Are these the final ones?’ At the very minimum it takes two weeks. In the US, they think it takes six weeks.

Whilst you are doing all this, I cannot see how you could fail to be influenced by the fact that you now know how the market received the decision you made. You know how the press received it, you know what you were criticised for, you know where you were told that you had left out such and such or where you had failed to take into account such and such. So I cannot see how that would not creep into your account, given that you cannot write down everything verbatim. I think that is one of the reasons why, at the end of the day, the minutes, when they come out, are such a committee document. They have been through so many hands, they have been massaged so many times and they have taken into account events that have happened since the policy decision. That is one of the reasons why I do not think they get a lot of attention.

CHAIR—That is a bit of repetition there. I think we have had that answer before somewhere.

Mr LATHAM—No. Hang on. We are in Wagga. We are here until 2.30 p.m. and then we will look at the beautiful city. I have a follow-up question: was the version of events in the *Australian Financial Review,* which came out within the week, correct or incorrect?

Mr Macfarlane—It was not correct.

Mr LATHAM—In what respect?

Mr Macfarlane—I cannot say that, but it was not correct.

Mr LATHAM—You mentioned earlier that in this country finance ministers and treasurers do not make commentaries or second-guesses or speculations about interest rates. At other times you have argued that, if they do do that, it is a sign of central bank independence. Would you like to see more of those comments to improve the bank’s credentials for independence in the marketplace?

Mr Macfarlane—I do not really have a strong view about that. The only observation I have made over the last year or so, during the period of raising interest rates, is that the Prime Minister has, on a couple of occasions, indicated that he did not see a need for interest rates to rise. But the Treasurer has stayed out of that debate, and that is okay with me. I certainly do not want him to come into that debate. In some countries, the treasurers have been known to come into the debate—traditionally in Germany that was quite common. But I think the arrangement works quite well at the moment, and I am certainly not going to say, ‘Please, Treasurer, come in and make frequent comments on monetary policy.’ I am very happy with the way he is handling it.

Mr LATHAM—On another matter regarding the Treasurer, after your presentation at the Queensland University of Technology—there was a bit of political argy-bargy about the stance of fiscal policy; I think the term you used was ‘bidding war’—you issued a quite extraordinary statement saying that you had been misrepresented in a press report. There were other press reports suggesting that the Treasurer had intervened to urge you to make such a statement. Is that true or false?

Mr Macfarlane—I have not got the statement in front of me. Can I have a look at it?

Mr LATHAM—It is 11 August.

Mr Macfarlane—I know the date, but I have not got the statement in front of me. This is not the first time we have issued a statement saying we have been misquoted. There was another occasion when a report emanated from, of all places, Jackson Hole, Wyoming, which was a completely incorrect statement, and we issued a retraction. In fact, I was not even in the country when that retraction was issued—I was still in Jackson Hole, Wyoming.

Mr LATHAM—To answer my question in regard to the speculation that the Treasurer had requested you to make such a statement—

Mr Macfarlane—No. If this were the only one I had ever made, you might think this was most unusual and that I must have been requested to. But I just made the point that there have been other occasions when we have believed that (a) something has been attributed to me which was wrong; and (b) where we think it has been damaging and we have put out a release. The full text of my answer to that question was made available to the press. So this was not a matter of me saying, 'No, I did not say this,' and them saying, 'Yes, you did.' The full text of the statement was out there. We recorded that, we had it typed up and we put it on our web site so that people could judge for themselves whether I was being misquoted or not.

Mr LATHAM—So you did not have contact with the Treasurer before this statement?

Mr Macfarlane—I talked to the Treasurer about it, but the reason we put out the retraction was our decision to do so.

Mr LATHAM—Just one final matter—which goes back to something I mentioned earlier on—was in your opening statement. It is almost like a business-as-usual comment that the banks forecasts had been undershooting. You say here, 'As usual, we were expecting a modest slowdown in the year to June 2000.' It did not necessarily come about. That sentiment is repeated in your Queensland University of Technology speech in which you say that, on forecasts, the bank tends to undershoot but your critics undershoot even more. That seems to indicate that there is an undershooting of interest rate increases—they are too low and too slow. I am just wondering, with hindsight, if there had not been a political controversy in May, would you have moved a bit faster and higher on rates than what transpired, rather than the increase we had in August?

Mr Macfarlane—No. It is true that those forecasts of growth undershot, but our forecasts of inflation overshot through most of that three-year period. It would be easier to make the opposite argument that we expected to see more inflation than we got. If that were the case, you would turn around and say, 'You should have been easier on interest rates.' You could make that argument either way.

Mr LATHAM—You forecast more inflation than you got?

Mr Macfarlane—If you forecast more inflation than you got, you could come along and say, 'Oh, I see, you were expecting a worse inflationary outlook and that is why you had to put interest rates up so much, and it turns out you were wrong. This inflation is lower, therefore, you should not have put interest rates up as much.' You could make that argument just as easily as you could make your argument which says, 'Growth was stronger than you thought. You should not have allowed that to happen; you should have had higher interest rates.' You could make either argument. I do not think either of them are valid, but you could make either of them; it is utterly symmetrical.

Mr LATHAM—So in hindsight you would not do it any differently?

Mr Macfarlane—In hindsight we are very happy with those five increases in interest rates. We are very happy that we made them when we did.

Mrs HULL—In relation to that—and you are very happy with all of that—can you outline the effect that it has had on the level of economic activity and also on employment?

Mr Macfarlane—It is very hard at this early stage. I think there was some evidence early on that some very overly exuberant consumer confidence moderated. That may well have had some modest effect on consumption. Traditionally, the first reaction of an interest rate increase is also to be felt in housing construction—although, as I have said, it is so difficult to tell now because events there have been so overwhelmed by the bringing forward due to the GST. But, at the margin, you would expect that inflationary pressures would be a little lower and that economic activity may be a little lower than it would otherwise be.

Mrs HULL—With your indulgence, Mr Chairman, students from Trinity Senior High School have been here all day and would like to ask Mr Macfarlane the following question: what is your view on the commencement of community banking in rural areas following the diminution of banking services provided by the major banks?

Mr Macfarlane—I think the community should be commended for any community activities like that. I do not know much about it myself, but I think that is the way a market should operate. If people are unhappy with the providers of the service they are receiving and they can get together and create an alternative supply, that is excellent.

Ms BURKE—In regard to the issue of independence—and given that the *Australian Financial Review* on the weekend put you as one of the most powerful people in the rise of the central bankers overall—you made a comment to this committee last May, in response to a series of questions Mr Latham asked you about the current government's policies on fiscal loosening, that it was a political issue and that you could not possibly make any speculation on it. In August, following your presentation to the Queensland University of Technology that Mark referred to, you had a question and answer session where you said that there was a bidding war and you were worried about—

Mr Macfarlane—No, I said I would be worried if there was a bidding war. I did not say one had happened.

Ms BURKE—Okay. Given that, and the subsequent release, do you think that governments are concerned that the Reserve Bank is becoming too much of a central player within the economic cycles, within the economic forecasts?

Mr Macfarlane—I do not know. You would have to ask the governments whether they are concerned about that. I have always felt that you would never really get a commitment to central bank independence until governments realised that it was actually in their interest to have it. There was no point in saying to them, ‘You should have this because it is a good thing’—you would never get the commitment. You had to reach the point where they actually realised it made their job easier. I think that, by and large, we are in that situation where it makes the government’s job of doing what it is supposed to do easier than it used to be. If we go back 10 or 15 years, every time a Treasurer walked out of a building he got asked questions about interest rates: ‘Why are they going up?’ et cetera. It completely dominated all the media discussion with him. That does not happen now, which is a huge improvement—from their perspective as well as from our perspective. From time to time, governments may feel, ‘Wouldn’t it be nice to turn the clock back,’ but I think most of the time they do not. I think most of the time they are happy with the system and they think that it makes it easier for them to do their job.

Ms BURKE—On the other score, isn’t it right that you also have some authority to make comment on government expenditure and fiscal direction and loosening as it does impact upon the monetary system overall and the economic flow?

Mr Macfarlane—If I thought fiscal policy was making it difficult for me to do my job, I would make those comments.

Ms BURKE—Thank you.

CHAIR—We have had a very good session here. Mr Macfarlane, Mr Stevens and Dr Laker, I would like to thank you very much for what has been quite a valuable session. I would also like to thank everyone else for coming along. For those who have not seen this before, I hope you have found it a very interesting exercise.

Resolved (on motion by **Ms Burke,** seconded by **Mrs Hull**):

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

Committee adjourned at 2.23 p.m.