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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

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SYDNEY

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 31 May 2002

Members: Mr Hawker *(Chair)*, Mr Albanese, Ms Burke, Ms Gambaro, Mr Griffin, Mr Latham, Mr Nairn, Mr Pyne, Mr Somlyay and Dr Southcott

Members in attendance: Ms Burke, Ms Gambaro, Mr Griffin, Mr Hawker, Mr Latham, Mr Nairn, Mr Pyne and Dr Southcott

Terms of reference:

Review of the Reserve Bank of Australia's annual report 2000-01.

WITNESSES

BATTELLINO, Mr Richard, Assistant Governor (Financial Markets), Reserve Bank of Australia 1

EDEY, Dr Malcolm Lawrence, Assistant Governor (Economic), Reserve Bank of Australia 1

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia 1

STEVENS, Mr Glenn Robert, Deputy Governor, Reserve Bank of Australia 1

Committee met at 10.00 a.m.

BATTELLINO, Mr Richard, Assistant Governor (Financial Markets), Reserve Bank of Australia

EDEY, Dr Malcolm Lawrence, Assistant Governor (Economic), Reserve Bank of Australia

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

STEVENS, Mr Glenn Robert, Deputy Governor, Reserve Bank of Australia

CHAIR—Good morning. I think it is timely, with the interest rate rise earlier this month, the first increase since August 2000, that we are having this hearing. I am sure that the governor will have a lot to say about that and other aspects of the economy. We will also be following up today on issues such as credit card fees and the economic outlook in Australia.

I would particularly like to welcome two new members to the committee—Mr Gary Nairn, the member for Eden-Monaro, and Mr Alan Griffin, the member for Bruce. I also congratulate the deputy chair on the recent arrival of her son.

We also invited the public to submit some questions via email. We have had quite a positive response on that. We might use some of those questions later in the hearing, if time permits. Once again, I welcome the governor and other senior officials of the Reserve Bank of Australia to this hearing today. I remind you that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of the parliament. Mr Macfarlane, would you like to make an opening statement before we invite questions?

Mr Macfarlane—Thank you very much, Mr Chairman. Yes, as is my usual practice, I will start with an introductory statement.

With the normal timetable interrupted by last November’s election, it is slightly over a year—I think you pointed that out—since we appeared before this committee. Since it has been an extremely eventful year, I will have a fair bit of work to do today to fill in the gap. Looking back over the *Hansard* of the last meeting in May 2001, I see that I was explaining why we had lowered interest rates three times, in February, March and April. At the time of that meeting, I was pretty confident that the Australian economy was on a recovery path after a short housing-induced setback in the second half of 2000. But none of us were sure what was happening in the United States and the rest of the world. External events were seen to be crucial to our fortunes and to the evolution of our monetary policy.

As it turned out, these external events unfolded in two very distinct phases. Over the rest of 2001, the world economy continued to weaken. The United States had a mild recession, with consumer spending holding up, and therefore preventing it from being as deep as earlier recessions. On the other hand, the US business sector had a pronounced recession, judged from the fall in industrial production, investment and profits. Most other major countries had negligible growth during this period. So for the G7 countries as a whole, growth over the calendar year 2001 was approximately zero. Even so, it looked for a time as though things could have been a lot worse.

For most of last year, therefore, we were receiving gloomy news on the world economy. We had a brief respite in mid-year, but then the bad news started to re-emerge in the July-August period, so much so that in Australia we eased monetary policy again in very early September—on 5 September, to be precise. Then, of course, the events of September 11 came along, and that induced a new bout of gloom. There was a real fear that the world economy would weaken further in 2002 and so experience a prolonged and deep recession. Monetary policy was eased virtually everywhere in the world. In our case, even though our own economy remained in good shape, we eased in anticipation that the weakening prospects for the world economy would flow through to the domestic economy. So that was the first phase.

The second phase began in the early months of this year when it became increasingly clear that our earlier fears about 2002 were not going to be realised. The US economy grew more quickly in the final months of 2001 and the first quarter of 2002 than anyone had expected. In addition, we received better news from non-Japan Asia and Europe. It is now pretty clear that 2002 will be a year of recovery for the world economy. The IMF is forecasting good growth through the year. The debate is no longer about whether there will be a recovery but about whether it will be an average or below average recovery. There is still a good deal of uncertainty about how robust the US recovery will be once the inventory correction has passed—that is, how it will fare in the second half of the year. Some of the bubble type distortions have not been fully unwound, so there is still a fair amount of caution around, including in the Federal Reserve Board. So we are in a world economy with a more comfortable outlook than a year ago, but with still some uncertainties remaining.

What of the Australian economy? The story here has been less exciting but the results have been a lot more satisfying. As you know, GDP grew by 4.1 per cent over the course of 2001, which was the highest amongst comparable OECD countries by quite a margin. We can now safely claim that the Australian economy has weathered a world recession without itself experiencing one. This is the first time in my experience that such an outcome has occurred and must give us confidence in the soundness of our economy. But before getting carried away, we should concede that, by the standards of earlier world recessions, last year’s was a mild and short one. Some observers may be reluctant to classify it as a fully-fledged recession at all. Also, we have to concede that we did not escape scot-free. If you average our growth in the year 2000 and 2001, it comes out at about three per cent, so we did experience a modest slowing.

As well as good GDP growth, we have experienced quite good employment growth over the past year. It appears that the slowdown in our economic activity resulted in a trough-to-peak rise in unemployment from six per cent to seven per cent and that half of that rise has already been whittled away so far in 2002. This is extremely good news because it is the first time for three decades that we have been through an international slowdown that has resulted in the peak unemployment rate in Australia being lower than its predecessor.

At this point in the proceedings, I usually review the previous set of forecasts and then present a new set for the period ahead. I apologise that a whole lot of figures are going to come out during this, but I will go ahead anyhow. We have to bear in mind that we have twice as many figures as we normally have because we have had twice as big a gap between meetings.

Last May, when we had only two of the four quarters of the financial year 2000-01 available to us, I said we expected year-on-year GDP growth in that year to be about two per cent. In the event, it came out at 1.9 per cent, which is very close. My forecast for year-on-year GDP growth in the current financial year, 2001-02, was three to 3.5 per cent. Our current forecast, still with two quarters to come, is 3.6 per cent or a bit above that. So even though there have been very big swings in the world economy and the international outlook in the meantime, the last 18 months seem to have turned out pretty much as expected for the Australian economy, unlike the previous six months, when the extent of the housing-induced setback took us largely by surprise.

On the prices front, when we met last time, we still had not seen the GST bulge pass through the figures. The forecast I presented at the time was that, when it had passed through, the rate of inflation measured by the CPI would settle at about 2.5 per cent. In fact, that was spot-on, because for the four quarters to the September quarter last year—that is, the first period that was free of the GST effect—the inflation rate over that four-quarter period was 2.5 per cent. But by the December quarter it had risen to 3.1 per cent and by the March quarter of 2002, which is our most recent figure, it was 2.9 per cent. So, on average, we slightly underestimated the rise in inflation.

For the year ahead, the financial year 2002-03, we are forecasting the economy to continue growing at 3.5 to four per cent as it completes the 11th year of its expansion and enters the 12th. The outlook for inflation over the same period could best be described as remaining near the top of our target range, although we expect it to go down slightly for a time and then to come back up. This was the view expressed in our quarterly statement on monetary policy released earlier in the month.

In short, the outlook for economic growth and inflation is such that the economy no longer needs the boost provided by an expansionary stance of monetary policy. We took the first step to returning monetary policy to a more neutral setting earlier this month. Unless unforeseen developments intrude, we should continue the process as we go ahead while all the time carefully examining incoming data, both from here and abroad, to ensure that developments remain on track. I will return to this theme later in my presentation, but before doing so I should examine the economic outlook in a little more detail.

In looking ahead, we always have to ask ourselves where the balance of risks lies. Another way of expressing this is to ask: what is the main risk for the economy if we did not adjust monetary policy and we kept it exactly where it is? In our view, the most important risk would be that the expansionary forces in the economy would increase to an excessive degree, bringing with it the likelihood that inflation would rise from its present position at the top of our target range to something in excess of it. In the process, we would also expect other imbalances to emerge which would ultimately bring the current expansion to an end. Of course, we cannot entirely rule out the alternative outcome, whereby the economy slows and puts sufficient downward pressure on inflation that it threatens to fall below the bottom of our range, but we would put a very low probability on that outcome.

As has been the case now for some time, to the extent that we can identify risks on the downside, they come mainly from abroad. Even though the US economy grew quickly in the first quarter of the year and is expected to show a reasonable growth rate in the second quarter, the strength of its recovery is still uncertain and there are risks to the world economy from the unstable political situations in the Middle East and the Indian subcontinent.

On the domestic front, the most easily identifiable area of spending that will exert a dampening influence later in the year is likely to be house building, largely because so many houses will have been built that construction will not be able to continue at its former rate. But, overall, barring some unforeseen international event, we find it hard to see serious risks on the downside for the Australian economy. We cannot rule out slightly below average growth, but we would regard anything significantly more adverse as unlikely. Instead, conditions are much more conducive to stronger economic growth than we have had over recent years. The turnaround in the world economy will mean that it will be a positive force for growth over the year ahead rather than a dampening influence, as it was last year. This should be good for exports, investment and confidence in general. As well, both consumer and business confidence returned to quite high levels after a couple of setbacks last year.

Business investment has been quite restrained over the past couple of years but is about to pick up, according to the plans businesses supply to the Australian Bureau of Statistics for their Capex Survey. This is not surprising, given the relatively healthy profit situation, the high level of business confidence and the expected growth in spending. These more buoyant conditions may also encourage businesses to attempt to rebuild profit margins, which will be a factor underpinning inflation over the next year or so.

Thus, we believe that, if monetary policy maintained its present stance for too much longer, there is little risk of a serious slowdown but a high risk that the economy in time would overheat. This provides the basis for our view that monetary policy should be returned to a more neutral setting. I think there is widespread agreement with this assessment of this situation, but inevitably there will be people who do not agree. One doubt you sometimes see expressed is the fear that any rise in interest rates will choke off the expansion. Not surprisingly, we feel that that fear is misplaced. At one level it amounts to saying that the expansion is so fragile that it can only be continued if monetary policy is kept permanently in an expansionary setting. We also care about continuing the expansion but feel that the least risky way of doing so is with a more neutral interest rate setting. At another level, the fear may be that we at the Reserve Bank will err on the tight side. Of course, that is possible, but our track record does not support this view.

Over the past decade or so, the thing that stands out about our monetary policy is the fast rate of economic growth it has permitted compared with other comparable countries, not any tendency to overachieve on inflation reduction. Where we differ from some observers is that we are mainly interested in the medium run; that is, we want to sustain the expansion rather than to maximise its speed over any particular year. We have been consistent in this approach for the best part of a decade and it has served us well.

I would now like to change to a subject that was highlighted by the committee in its press release announcing today's hearing—namely, credit card reform. The Reserve Bank released its consultation document in December last year. In it, we proposed, subject to further consultation, three major changes to the four-party credit card schemes that operate in Australia. 'Four-party' means Visa, Mastercard and Bankcard.

The first change is that we want to see a new and transparent standard for setting the interchange fees on credit card transactions, which would lead to a reduction in those fees and thus in merchant service fees paid by businesses. Secondly, we want to see the ending of the prohibition imposed by the card schemes that prevents merchants from passing the cost of accepting credit cards on to cardholders. Thirdly, we want to see the elimination of the restriction on entry to credit card schemes that keeps out potential competitors that are not deposit-taking institutions.

After we released our document containing these proposals, we allowed interested parties until mid-March to prepare submissions. We have been going through those submissions thoroughly with them since then. We want to give each party every opportunity to put their view forward, even if it involves multiple meetings. We are still in this process and, when we are finished, we will release our findings—some time after the end of June. During this period, we at the Reserve Bank have not engaged in public debate on this subject, even though some other participants in the credit card industry have been quite vocal. We see our role in this stage essentially as the umpire adjudicating between the competing views of the financial institutions and card schemes on one side and the consumers, retailers and billers et cetera on the other side. Of course, our umpire role should not inhibit the committee from asking any questions that it wishes to. Thank you very much, Mr Chairman.

CHAIR—Thank you, Mr Macfarlane. I am sure we will take you up on that offer. First of all, could I have a motion that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication?

Resolved (on motion by **Ms Burke**):

That the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication.

CHAIR—Thank you very much for that opening statement, Mr Macfarlane. It is very heartening to hear the continuing positive views you have about the Australian economy. It is a remarkable run that we are having. I would like, first of all, to get a definition from you. In your statement you talked at some length. Summarising it, you still have a concern about the continuing expansion but feel the least risky way of doing it is with a more neutral interest rate setting. I was wondering whether you would care to expand on your definition of what a more neutral interest rate setting is.

Mr Macfarlane—I thought you would ask that question. In fact, in truth, it was asked last time. Mark Latham asked that question last time. I gave an off-the-cuff answer. I said at that time a neutral interest rate setting was a real interest rate of about 3½ per cent. In fact, I half expected that, by saying that, it would be interpreted by the media as a new rule of monetary policy. Fortunately, no-one made much of it. This is fortunate, really, because the concept of a neutral interest rate is a lot fuzzier than just producing one single-point estimate.

We have done a lot more research into the matter using various measures of inflation and inflationary expectations and looking at the historical record over different time periods. If I were asked the question today—and I have been asked the question today—I think we would express it as a range rather than as a single point. I think the range is actually slightly lower. In other words, the 3½ per cent is what I would tend to put at the top of the range. I think really somewhere between three and 3½ per cent would probably be the best shorthand answer to that question, although I have heard people put forward 2¾ per cent, and I also know of another stream of thinking which would put it a good deal higher and have it at four or over four. But for present purposes, three to 3½ is not bad.

The truth of the matter is that it does not make a huge amount of difference at the moment because whatever measure I have heard put forward is higher than where we are. So for present purposes, we know that we are below whatever the neutral one is. The concept of ‘neutral’ is actually most useful to you if you are well below it or you are well above it. It gives you a reference point to start thinking about for the medium term. Once you are actually in there, I do not think you would be making your decision on monetary policy by having fine pencil calculations of exactly what is neutral. The importance of neutrality is to remind you when you are a fair way away from it where the medium-term position should probably be, unless you are suffering some obvious contractionary influence or some obvious very expansionary influence. It reminds you of where you probably ought to be.

CHAIR—You mentioned in your opening statement and in the monetary policy statement the question of the benign inflation outlook. This is in the monetary policy statement that I am reading. You say:

Recent statements have presented a relatively benign inflation outlook, stating that inflation would decline to around the middle of the target spanned over the course of 2002—

which I think you restated using different words today—

and the Bank's assessment of this outcome is still likely over the coming year, particularly given the recent tendency of the Australian dollar to appreciate, which should help further dampen inflation pressures in the tradable sector.

Then you talk about the strengthening domestic economy and so on. Given that the dollar has appreciated by at least 10 per cent against the US dollar and your expectation, at least over the rest of this year, is that inflation could decline, does that reduce the pressure for further interest rate rises in the short term?

Mr Macfarlane—I will answer the bit about inflation rather than the bit about the dollar, because I think there are probably other questions that will be asked about the dollar. I mean, essentially what is happening in an inflation forecasting sense is not that people are saying, 'Gee, look, the exchange rate is rising quickly.' The exchange rate is doing something similar, too. It fell to a very low level. The effect of that fall was coming through into our inflation forecasts. Some of that is now going away because the exchange rate is moving part-way back towards something which is more normal. That is, of course, all reflected in our inflation forecast. It is not as though the exchange rate is reaching some new level where it has not been before. What it is doing is retracing part of a very big fall. The net effect of what exchange rate movements have been over the last two years is, in net terms, that they have been inflationary. But the extent to which they have been inflationary is being reduced by the recent retracement of the exchange rate. That helps to explain why in the profile of our forecasts we think we might be wrong. But we expect we will get slightly better news over the remainder of this calendar year. We think as we go ahead, with the economy continuing to grow at the sort of pace that it has—and we expect it to continue to grow—the pressure would be really more upward than downward.

CHAIR—In New Zealand, we have seen three interest rate rises recently. The official rate is one per cent higher than in Australia. There was an increase on 15 May. In commenting on this, first of all, the former Reserve Bank governor, Mr Brash, suggested earlier in the year that interest rates would rise by a full percentage point by the end of the year and the Acting Governor, Mr Carr, in his press release on 15 May, when talking about the increase up to 5.5 per cent, made this comment:

At this point, it appears likely that further increases in interest rates will be required over the year ahead, possibly to a greater extent than we projected in March.

I do not wish you to comment on what New Zealand's decisions are, but I would be interested in how you respond to that approach by the Reserve Bank in actually putting forward statements as aggressively as that about where they think interest rates are going over the next 12 months.

Mr Macfarlane—There are two things, I suppose. Our financial markets implicitly give a forecast of what their combined wisdom thinks interest rates will do over the next six months, 12 months and 18 months. So it is not as though they are in total ignorance and they have to be led by me in order for them to make a judgment of where they think they are going. That information, in a sense, is already out there. It is already in the collective consciousness. Unless I wanted to disagree with the sort of assessments they are making, I wouldn't feel the need to say to them, 'No, it should be X amount higher or Y amount lower.' So there is already out there an assessment of where people think short-term interest rates are going to go.

The second thing is that it is pretty obvious if I say that, unless unforeseen events intrude, our interest rates should return to normal or to neutral—and we know that neutral is higher than we currently are—that that statement does imply an expectation about the direction in which interest rates will move in Australia. It gives some rough quantitative bound as to what that could be. So I do not really feel a need to come out and say anything more than that, because it seems to me that there is already an awful lot of information about both what the market thinks we are going to do and what we have said we think, other things being equal, will happen.

CHAIR—I suppose I would comment about two things. Firstly, the market is not always right. Secondly, anything you did say would certainly still be very significant.

Ms BURKE—I want to lead on from that. Are you saying neutral and normal are the same, given that on page 38 of the monetary policy statement you said 'has led markets to price return of official rates to more normal levels'. If neutral is three and we are at 4.25, what is normal and what is neutral? What is the rate?

Mr Macfarlane—Hang on. I think people do use the terms 'normal' and 'neutral' interchangeably. But the figure we talk about is real. In other words, it is taking inflation out of it. That three to 3½ range that I mentioned is the real interest rate. You have to add inflation to get the nominal interest rate. But the main answer to your question is that I think the words 'neutral' and 'normal' are used interchangeably.

Ms BURKE—But the notion from the report, and leading on from where David has just been, is that you were continually saying that the markets were expecting the rise. So, I suppose, is it the market which is dictating the rise or is it the Reserve Bank that is dictating the rise in interest rates nowadays? Is the market leading you, or are you leading the market?

Mr Macfarlane—Basically, the markets are looking at the same information that we look at. They are making an assessment, given the information that is coming in and given that we think the economy is going to go in a particular direction and these are going to be the pressures on the economy, of what the central bank would do in those circumstances. In some sense, they are making an assessment. First, they are making a judgment about the economic statistics and, second, they are making an assessment of what they think we are going to do. The thing is that they are doing it every day. In fact, they are doing it every minute of the day.

The second part of your question was: because they do that, is that leading us? The answer is no. I suppose the best way I can illustrate this is that, in a sense, markets always move earlier than central banks. They always do, but they sometimes get it wrong. Sometimes they move earlier and then they change their mind and they get it wrong. They then move back the other way. A very good example of that would be in

Australia last year, where we had these three quick falls in interest rates and then in the period in about June the markets decided that it was all over and there were not going to be any further falls in interest rates.

You can read it off the yield curve. They showed that there will be no further falls and we will be entering a period of rising interest rates. They were well ahead of us, but it turned out they were wrong. It did not happen. We put interest rates back down again. Then September 11 came along, which of course no-one could be blamed for missing, and it went down even further. But the important thing is that in that mid-year episode the markets did get ahead of us and they were wrong. Very often they are right, but they are also sometimes wrong. But they are certainly always ahead. They always move earlier—maybe someone could find an exception somewhere—but by and large they are ahead. But that does not mean we have to follow. Sometimes they go ahead in a particular direction and we do not follow.

Ms BURKE—The markets are predicting, though, that there would be a one percentage point rise as opposed to the quarter per cent. You have made those statements as well. Do you see that over the course of the next 12 months or whatever we will be seeing interest rates rise more gradually and more significantly?

Mr Macfarlane—We follow the markets' assessment every day. You see it. It is the yield curve. It is just a line, and it is quite upward sloping at the moment. But it moves about from day to day. It moves about, of course, over the course of the month. I do not want to argue with the markets' assessments. I think most of the time they are reasonably good. Occasionally, as I pointed out in the middle of last year, they get it wrong. But I do not really particularly want to argue one way or another with their assessment.

Ms BURKE—So do you think the 25 per cent basis points was enough to ensure the offsetting inflation concerns?

Mr Macfarlane—Are you referring to the 25 basis points that has already happened?

Ms BURKE—Yes, that you have just done.

Mr Macfarlane—I think my introductory speech indicated that that was highly unlikely. Unless some unforeseen events intrude, one would expect in the normal course of events that interest rates would move back to a neutral or normal position if the economy still continues to perform well.

Ms BURKE—Have you done any assessment, then, on the impact of that and the increasing rates that you are predicting or seeing that may happen on actual household debt, given that you have quite clearly stated in both your annual report and the monetary policy that households are overstretched and you are concerned about household borrowings? Have you actually looked at the impact that this rate rise will have and any future rate rises will actually have on households overall?

Mr Macfarlane—You are introducing a pretty big—

Ms BURKE—Sorry.

Mr Macfarlane—That is okay. I do not mind. It is a pretty big subject. I think my first response to you will be that we have not said that the household sector is overextended. What we said was that, if present trends continue, there is a risk that that could happen. But we are not making the judgment that it has happened now. We do not believe that it has happened now. But if we continued to have, for example, household credit growing at 15½ per cent per annum, which it has over the last six months, or 18 per cent, which it has over the last 12 months, I think we could find ourselves in a situation where the sector as a whole was overextended. But we do not believe we have got there yet.

We do spend a fair bit of time looking at this subject of household debt. In fact, this committee has often asked about it. During the period that we have been having these meetings, household debt has continued to grow very strongly. The various measures that you can use to judge it have risen. The household debt to income ratio has approximately doubled over the last decade. So the Australian household sector has gone from being a very conservative one by world standards to being one which, judged by that variable or that measure, is similar to other comparable countries.

If we look around, we see that the United Kingdom, the United States, New Zealand, Canada, Japan et cetera have a ratio of household debt to household income of a bit over 100 per cent, and we are now in that league. Having started at about 50 per cent, we are now up there at about 100 per cent. A business person would say that you should not look at debt to income because you are comparing a stock with a flow; you should look at debt to the total value of assets. If you do that, it has not risen anywhere near as much but it still has risen. I think our latest figures suggest that debt to total value of assets has gone up from about 10 per cent to 14 per cent. I do not want to go on and on about this. I am happy to talk about this subject because it is an interesting one.

CHAIR—We might come back to that. We will look at monetary policy first.

Dr SOUTHCOTT—Governor, I wonder whether you are familiar with the paper that was presented by Don Harding of the University of Melbourne at the Melbourne Institute conference last month, which in summary looked at the business cycle for the last half of the 19th century compared with the last half of the 20th century in Australia and found not much difference in the business cycle. His conclusion was that monetary policy has not been successful in smoothing the business cycle. Have you seen the paper, and do you have any comments on it?

Mr Macfarlane—I have not seen the paper, but a couple of our people know something about it. In fact, I think Glenn might. My understanding is that he is looking at these really long-run periods. So he is comparing the whole second half of the 20th century with the whole second half of the 19th century. Whether or not his conclusion is true, I do not know. But I am not talking about things like that. I am talking about a much narrower issue. I am talking about the expansion we are currently in, which is really 11 years. I am comparing that with what happened in the 1980s or the 1970s or even what happened in the 1960s. The 1960s ended up in the 1970s. I am saying that if you look over that sort of period—I am doing a decade-by-decade comparison—I think there is not much doubt that this expansion has been longer and smoother than its predecessors.

My understanding is that he was looking at something much broader. I am not sure. I do not want to do him an injustice by taking issue with how he did it, but all I can say is that I think he was talking about a different subject from the one I am talking about. Glenn, is there anything you can add?

Mr Stevens—I have not seen the paper. But I think on work that we have done it is quite clear that the volatility of the economy—the short-run volatility of GDP—is lower in the 1990s than it was in the 1980s, which is lower than the 1970s and so on. We have done work on that, and I think that is a pretty clear result. There is more than one reason for that. I do not think we would claim that monetary policy alone is responsible for that decline in volatility. But we would claim that it has made a contribution. Other things have happened too, one of which is that the economy itself is just inherently more resilient and is better able to cope with shocks than it used to be.

I think it is pretty clear, just from simply looking at the data, that the trend in short-run volatility has been going down over the past 10 to 20 years. As Ian says, I think taking a 50-year period and comparing it with another 50-year period, where the data quality would have been much lower, is quite a different question. A lot of other things would be intruding into that calculation. But over a 10-, 20- or 30-year horizon, the volatility of the economy has been going down.

Dr SOUTHCOTT—I want to ask a follow-up question to that. In previous committee hearings, Governor, you have talked about your aim for stability in the setting of monetary policy. In your comments, you said that a neutral stance was a real interest rate of three to 3½ per cent. If the long run of the CPI is 2¼ or 2½ per cent, why not just keep the short-term rate at 5¼ or 5½ per cent? Some people have put it to us that, even though the magnitude of the changes in interest rates is much lower than it was in the late 1980s and early 1990s, the Reserve Bank may still be changing interest rates too often.

Mr Macfarlane—I gave a speech on that subject. The important thing to remember is what I am talking about here is an average. Interest rates have to go up and they have to go down. They always have and they always will, no matter what monetary regime you devise. You can go back to the history books and get gold standards, commodity standards and currency boards. Interest rates have to move up and down. If you tried to propose an alternative regime which had the nominal interest rate remaining stable, that is what is known as an explosive situation. If the nominal interest rate tried to stay stable, you would end up with either hyperinflation or deflation. The speech goes through exactly why that is the case. It is important to remember that it is always the average around which the interest rate moves. It is not a desire to keep it there. It is the economy we want to be stable, not the interest rate.

Mr LATHAM—Mr Macfarlane, could I just clarify the parameters that we were talking about earlier. The neutral interest rate settings are in the band of three to 3½. Real interest rates at the moment are about two. That is a gap of one to 1½ per cent. Could I just clarify that that is the ballgame that you have put us in today?

Mr Macfarlane—You can argue about the exact numbers, but the reason we introduced the concept of the neutral real interest rate is not because we want to have an argument about exactly what the number is or who calculated it this way or that way but just to remind people that where we are now is clearly well below anyone's definition of the neutral real interest rate.

Mr LATHAM—To move into that band, the nominal interest rate would lift it to about six per cent. Some people may say that is not too bad compared with the early 1990s. But how do you equate the two situations now, particularly with the rise in household debt and the fact that Australian households must be more affected by a relatively small interest rate rise than they would have been 10 years ago? Do you model these sorts of impacts? Do you have a framework for the impact of these interest rate rises on the average Australian household and their debt exposure? Does the bank still subscribe to its small licks or small nudges strategy; that is, it is best to move at 25 basis points, if that is manageable?

Mr Macfarlane—You have got two big questions there. The first one comes back to household debt. We may as well get on to that, I think. If you want to do other things beforehand—

CHAIR—We will deal with other things. Can we just take the second part of your question.

Mr Macfarlane—The second one is: do we move in small bits or in big movements? I think if you made a very large movement, you would run the risk of destabilising markets by quite a big amount. Whether we like it or not, the world has now moved into an era where changes by central banks in interest rates tend to be quite small and everyone expects that they are going to be small.

It is not that long ago that we were prepared in this country to move by what were seen as quite big amounts. For example, in 1994, two of the three tightenings were by 100 basis points. The last time we went through a tightening phase, one of them was by 50 basis points. The world has come to expect that movements will tend to be reasonably small. It does not rule out a 50, but 25s or 50s have now become the sort of range that people would expect, with the 50 being unusual and 25 being normal. I think the reasoning behind this is that people expect you to be very observant and to be constantly analysing new information as it comes in.

You may think that there is a good case to do it all in one hit, but you would have to be a very confident person to do that. I think, with the way the world operates now, people think that if you want to move from one particular position to another position you will do it in a series of steps. In between each one, you will pause, you will have a look and you will evaluate information that is coming in. In that sense, we are like virtually all the other central banks in the world in that we now follow that practice.

Mr LATHAM—But that relates to the other question. You do that because the smaller increase now has the same impact as the bigger increase might have had 10 years ago because of the changing nature of the household balance sheet.

Mr Macfarlane—Even before we get on to household balance sheets, it is quite clear that if you are in an environment where you have low inflation and low inflationary expectations, interest rates do not have to do as much work as they used to in environments like the 1980s, when you had higher inflation and a belief that this high inflation was here to stay and would never go away again. Even without appealing to the subject of household balance sheets, it is quite clear that the required size of the monetary policy move to get any given effect is smaller than it was.

Mr NAIRN—Governor, you said in your opening statement that there was a high risk that the economy in time would overheat. Would your concern come from, partially or fairly substantially, the escalating property market, particularly in Sydney and probably to a lesser extent in the other capital cities? Consequently, is that having an influence on the board's decision with respect to the movement of interest rates? Given that we do not have that circumstance throughout rural and regional Australia, how much do you take that into account as far as balancing the decisions is concerned? Certainly there is a dramatic difference between what is happening in the property market when you compare particularly Sydney and, I would say, most of rural and regional Australia.

CHAIR—Can I say that I did not put him up to that! I am glad someone else asked that question.

Mr Macfarlane—The other subject which I thought was bound to come up is house prices. Household debt and house prices—

Mr NAIRN—I know it is related.

Mr Macfarlane—I am not quite sure—

Mr NAIRN—I am talking specifically here about interest rates.

Mr Macfarlane—I am not quite sure how we go about discussing them. I will just discuss a particular point about your question first before we get on to the broad stuff. The recent rise in house prices in Australia—when I say 'recent', I mean over a five-year period—is interesting in that it is actually relatively widely spread. Certainly it is widely spread amongst capital cities.

Mr NAIRN—Capital cities.

Mr Macfarlane—Sydney is not by any means the fastest. Melbourne is a lot faster than Sydney. The thing that is interesting this time is that Perth, Brisbane and Adelaide have been participating. So the thing that makes this particular rise in house prices different from some of the ones we have had in the past is how widespread they are, at least across capital cities. My understanding is, whilst it does not extend to the whole of Australia, it also has extended to some regional areas as well. Certainly if you go north or south of Sydney—

CHAIR—Some of the coastal regions?

Mr Macfarlane—Yes. The coastal regions of Australia in general. I want to point that out. The second thing I want to point out is the answer I always give David when he asks the question is somewhat like this: you have to make monetary policy for the average of Australia. We always know that around that average there are going to be deviations, where some regions are pretty hot and some regions are pretty cold. My only point is that I think that deviations around the average now are smaller than they normally are. It is certainly the case on the particular indicator you mentioned, which is house prices. I think it is true of incomes and other things as well.

The deviation between the capital cities and rural and regional Australia was more pronounced three or four years ago than it is now. I think rural and regional Australia has had a good couple of years in general now. Obviously, if I went to each particular place, I could find exceptions to that statement. But as a general statement, I think it is reasonable.

Mr PYNE—I am just following up Mr Nairn's point. With respect to household debt, therefore, one of the reasons why circumstances might be different now for household debt is because household assets are actually increasing more broadly across Australia than they have been in the past as well. Is that right?

Mr Macfarlane—Yes, that is right. That is why that ratio of household debt to household assets has not risen as much as household debt to income has. In other words, the assets have been going up not quite as fast but almost as fast as debt.

Mr PYNE—The comparison of household debt to household assets is a much more useful comparison than the comparison of household debt to income, is it not?

Mr Macfarlane—Certainly business people would say that, because that is what you would look at if you looked at a business. It seems to me that every time a question gets asked, it comes back to household debt. Can I actually spend a bit of time on the subject?

CHAIR—Go for it.

Ms BURKE—He asked, though: do you sell an asset or not? That is the question, is it not? Someone is not about to sell their house, are they, to realise that asset?

Mr Macfarlane—One of the reasons that we keep coming back to household debt and house prices, of course, is that they are very closely related. When we talk about household debt, 86 per cent of household debt is housing debt. So they are very similar items. The other 14 per cent is a number of small things. Five of that 14 is credit card debt. Three of it is margin lending. I cannot remember what the other ones are, but they tend to be quite small. The big item is that 86 per cent. Of that 86, there is a very surprising fact there, which I am not sure whether people are aware of. Of that 86, 26 of the 86 is investment housing loans; it is loans for investment housing. So 26 of 86—in other words, 30 per cent of the housing loans made in Australia—are for investment properties, not for owner occupation.

Mr NAIRN—Has that risen dramatically in the last 10 years?

Mr Macfarlane—I cannot give you the answer to that. I suspect it probably has, but I have not got the figure on hand just at the moment. The reason we are talking about household debt and house prices at the moment, and these two things which are closely related, is because of their relationship to monetary policy. The first thing I have to say on house prices is that monetary policy cannot target house prices. House prices are something that happen but we cannot actually set our monetary policy to achieve a particular outcome for house prices.

But that does not mean that there is not a relationship between monetary policy and house prices. In fact, if you go back over the whole decade, we have to concede that the reason there has been this big lift in house prices is largely because we have moved from a high inflation, but more particularly high interest rate environment, to a low interest rate environment. Just think how a bank makes a loan to someone. They work out your servicing capacity; how much interest you can afford given your income. If interest rates halve, as a very crude rule of thumb, you can now afford twice as much debt as when interest rates were twice as high. And that has happened.

Basically, as we move from a high interest rate environment to a low interest rate environment, households could afford to service much bigger debts than they could in the past. So they have taken advantage of that capacity. They have taken out bigger mortgages. Once you have the capacity to take out bigger mortgages, they have the capacity to pay higher prices for houses. So this decade to decade shift from a high interest rate environment to a low interest rate environment has fed through into a significant rise in house prices.

The good news, to me, is that it cannot happen again. We have gone from a high interest rate environment to a low interest rate environment. There is not a lower interest rate environment to go to, unless we were to end up in deflation like Japan has, and none of us want that to happen. So this once-off event has happened. The markets did not do it all in one year; they did it over the course of a decade. But the once-off fall has happened. We should not expect to see the same sort of trend growth in house prices in future because they are not going to get that stimulus they had last time.

That does not mean that everything will go smoothly, because asset prices have a tendency to overshoot. It is quite possible that in the process of going from A to B some overshooting occurs. I sincerely hope that does not happen. That is where I think monetary policy comes in. We are aware that that is a risk. We would hate to think that we contributed to it by keeping a very low interest rate environment for too long. We would not like to think that when people look back, they say, ‘These wild excesses happened in the housing market. Who was responsible?’ We would not like to think that we had to put our hand on our heart and say, ‘Well, we were partly responsible because we kept the rates down too low for too long.’ Now I do not think that is going to happen. I do not think we are going to get that overshoot. I sincerely hope it does not happen because those sorts of events are very disruptive. We saw it happen in the UK in the late 1980s and we saw it happen in Japan. I do not think it is going to happen here, but, if it did, it would be extremely distressing for a lot of people.

Ms BURKE—I have two points from that. Are banks doing their risk management appropriately when lending people money and factoring in growth in interest rates, which you have said are going to happen? Second, do you expect every real estate agent to come out and beat you over the head like they did last time you said that housing prices should be going up? Is it realistic for that market, a different market, to have a go because you are making statements about how housing prices should be going? I was kind of surprised that they made such a song and dance when you made a little statement in your monetary policy about housing prices.

Mr Macfarlane—I am not really worried about what our critics say; that is not a big problem to me. I do think it is reasonable that this committee kept, when they asked questions, coming back to this issue of household debt and house prices. I do think there is a tendency sometimes for people to see it in a very one-dimensional way.

There is still a question that has been asked, which I have not answered, which is that question of: when interest rates go up, will it cause distress amongst households? In answering that, we have got to look into what we mean by households. It may surprise you to know that I think the figure is that only 30 per cent of households have mortgages. Is it 30 or 40? I cannot remember. The other 70 per cent are either the lucky ones who own their houses outright or people who are renting.

A lot of those people who are renting are actually hoping to buy a house; they are the younger generation who want to buy a house. For them, the big fear is unreasonably fast growth in house prices. That is the thing they fear. That is the thing they think might lock them out so that they will not ever be able to enjoy home ownership. So when we talk about the relationship between house prices and monetary policy, we have to remember that there are two groups out there. There is one group that have recently got a mortgage, so their mortgage is large compared with their income. These people obviously do not want to see interest rates go up. But they do not mind house prices going up at all because they have just bought one.

The other group of people aspiring to get into the housing market probably do not like to see interest rates go up either. But their biggest fear is not that; their biggest fear is an uncontrolled, rapid rise in house prices. So you have actually got to consider the interests of both of these groups when you make a decision about monetary policy or what effect it may or may not have on house prices.

Mr LATHAM—Mr Macfarlane, in your opening statement you said that if interest rates did not lift—and I quote here:

> ... we would also expect other imbalances to emerge which would ultimately bring the current expansion to an end.

Are you talking there about an imbalance in the housing market? If so, what is the exact nature of the imbalance and what is its cause?

Mr Macfarlane—Let me start by saying that I do not think we are going to have an imbalance. I just want to reassure everyone. I have been saying for a long time when I have explained why our expansion has lasted so long compared with, for example, that other well-known and much more heralded expansion—the US expansion—which ended: the reason ours has lasted so long is that we have not had a major imbalance.

I went back and explained the sorts of imbalances you normally get in the later stages of an expansion. We have not had one. We have not had an asset price boom. We have not had an investment boom. We have not had a wage blowout. We have not had a lot of the things that you usually have. A lot of people say to me, 'Oh yes, but we have got an incipient imbalance,' being an asset price boom and bust in housing. And that has to be seen as a possibility. But I think if we conduct our monetary policy properly and people are sensible, and people recognise that one-off nature of the shift from a high to a low interest rate environment, we will not have that sort of imbalance. But that is a possibility. Of the various possible imbalances that could occur, that would be probably the one you would think of, although I do not think it is likely.

Mr LATHAM—Are you concerned about the most recent figures about the Sydney housing market showing year-on-year asset price increases of 50 per cent, which one would have thought is a pretty big boom? Could I also ask: is the bank deploying the strategy on which you had a research paper a few years ago regarding asset price bubbles and monetary policy, where really you are trying to lift interest rates to pre-empt an excessive bubble and to bring it into some sort of moderation before it gets too bad and ends up in a big bust that impacts on the stability of the financial system? It was a very good paper.

Mr Macfarlane—Yes. The answer to the second one is no. If we were following that strategy, we would have put up interest rates by a lot more. So we are not following that strategy because we do not think it is as big a risk as would be implied in that paper. I also want to mention again that a lot of things occur in Reserve Bank discussion papers which are for the general edification of the world and to keep bright people thinking laterally. They do not necessarily reflect exactly what I think at any particular time. But I am very pleased to see that you read them. That was your second question. I have forgotten what your first one is now.

Mr LATHAM—Well, the most recent increases in Sydney property prices. There have been figures in the last fortnight showing year-to-year increases of 50 per cent, which are way bigger than anything that was seen last year.

Mr Macfarlane—I have not seen that figure. The problem with house prices is that there are at least three different measures that are widely quoted. The one that we have tended to give most credibility to in our recent research does not show figures anywhere near as high as that. You have it there, have you, Glenn?

Mr Stevens—Yes.

Mr Macfarlane—The other thing it shows is that over the last year, or even over the last three years, Melbourne prices have gone up considerably faster than Sydney prices.

CHAIR—You'd better reopen that office down in Collins Street now!

Mr Macfarlane—I will ask Malcolm to elaborate.

Dr Edey—I will add to that. We quoted in the latest statement figures up to the December quarter of last year for house prices. There have been new figures out in the last couple of weeks for one of the measures, which is the Commonwealth Bank-HIA measure. But that is showing rises over the year in the range of 15 to 20 per cent for the capitals. Sydney would be within that range. So I have not seen a figure that looks anything like 50 per cent.

Mr LATHAM—There were Sydney suburbs that were 50 per cent, in figures that were released during the week.

Mr Macfarlane—You would find it in individual suburbs, I am sure.

Ms BURKE—Mr Chairman, can I move away from housing to exchange rates, or do you want to deal with—

Mr LATHAM—Can I ask one last question on housing. Do you think there is a risk that people in the housing market are becoming a bit oblivious to interest rate movements in that asset prices have increased so substantially that there could be a mindset of expectations whereby people are thinking that, no matter how interest rates might rise, the asset price will continue to grow at a faster rate and that your pricing signal has not been as thoroughly received in the market as it needs to be?

Mr Macfarlane—There is a risk. I do not think it will happen this time. I think that is part of what happened in the late 1980s—that people had in their mind the idea that various assets would go up by 20 or 30 per cent per annum. In that environment, strange as it may seem, they were not even deterred by interest rates of 18 per cent or so, which we now look back on and say, ‘How on earth could they have got so high?’ That is always a risk, but I do not think that is going to happen this time. As I say, a lot of it is there has been a one-off event which explains why those house prices went up. That one-off event, first, cannot be repeated, as I said, and, second, will be going in the opposite direction if our forecasts are realised over the next 18 months or so.

CHAIR—Before we come to exchange rates, Mr Pyne and Mr Griffin have questions on housing.

Mr PYNE—Mr Macfarlane, following on from Mr Latham’s question, since you raised interest rates by 25 basis points, have you had a chance to monitor increasing housing prices since that time to determine whether in fact there has been a slowdown or a trend emerge?

Mr Macfarlane—We cannot really deal with house prices, but there are various indicators. We do look at a lot of stuff. I mean, you look at auction clearances and you get stories on that. But I do not think you would expect to see an instantaneous reaction from a 0.25 per cent rise. You would not expect to see it. But can I say another thing about the housing market that gives me reason to think that good sense will prevail. In some parts of the housing market, particularly inner city apartments, it is quite clear that vacancy rates are up. People are having trouble letting them. There is some evidence that prices are already going down in that area, which is what you would expect, given the massive increase in supply. So we have a situation where overall average measures of house prices are still going up, but we can see in some important areas that oversupply has already occurred. I think the recognition of that will gradually come.

Mr GRIFFIN—Mr Macfarlane, you mentioned before that, in moving from a high interest rate environment to a low interest rate environment, effectively the capacity for people to double their debt ratios was there and that it is therefore manageable. In response to that, when we are looking at a question of interest rate rises, comparing them now to, say, 10 years ago, are we actually talking about a situation where they are likely to have double the impact or more or less?

Mr Macfarlane—It is something we look at closely and we are aware of. You know, we calculate the change in debt servicing as a result of different changes in interest rates. You get a different result than you used to have when people had small amounts of debt. Can I actually read out the figures. As I told you, only 30 per cent of people have a mortgage. We read stories in the paper about young people taking out massive mortgages. It sounds quite frightening. But the truth is the average new mortgage that is taken out is about $160,000. The average mortgage that is sitting out there, including mortgages that have been running for a number of years, is about $74,000. I suspect, however, that in the investment housing end of the market, I think that is where we are going to discover a lot of the overextending will have occurred. I think there will be a tendency there for people to take out bigger mortgages, because a lot of the activity there is really tax-driven.

Mr GRIFFIN—If that is the case, and it may well be, you mentioned earlier the question of the potential dropdown with respect to, say, inner city apartments and so on, which often would be investment housing. I suppose there is potential there for a situation where people have gone into an investment on the expectation of valuation increases and being in a position whereby they are already starting to get caught.

Mr Macfarlane—That is quite possible. I would think to the extent that pressure starts to be felt first, I think it will be felt in the investment area rather than in the owner occupied area.

Ms BURKE—I want to jump in very quickly. If you are saying that there are only 30 per cent that have actually got a mortgage, and we are looking at household debt, are there other areas of debt that you are concerned about? You mentioned fleetingly credit cards. Credit card interest rates have not come down ever. They keep going through the roof without seeming to be monitored or curtailed by anybody. Is there a risk about households servicing credit card debt and other forms of debt?

CHAIR—Can we keep it to the question of debt. The credit card issue we will come back to in general terms.

Mr Macfarlane—The sort of topic we are talking about now, credit card debt, is a small player. But if we were looking at particular people and particular instances of distress, it might be much more important. Of what we are talking about at the moment, it is only five out of the 100.

Ms GAMBARO—May I deal with exchange rates and monetary policy?

CHAIR—Yes. Go right ahead.

Ms GAMBARO—I would like to ask you whether the Reserve Bank is at all concerned that the exchange rate might be increasing too far and eroding the competitiveness of Australian industry. To what extent is the recent gap between the Australian and US interest rates, especially those short-term rates, boosting the Australian dollar?

Mr Macfarlane—The first thing I would like to say in answering a question about the exchange rate is how quickly people's perceptions can change. Last year and the year before, when the dollar was plunging, we all thought, 'This is terrible.' The newspapers were full of stories about the world voting with their feet and they have dropped us. When the Australian dollar got down below US50c to 48c or something, people were saying, 'This is ridiculous. How could it be so low?' One of the newspapers had a picture of dollar bills disappearing down the drain as their front-page picture.

Yet now, after the dollar has recovered a little bit, we fall into the trap of using that exceptionally low level as the base point for our comparisons, as though somehow or other that represented normality. So my first plea is that when we are looking at the exchange rate we should compare what is happening now with some sort of average behaviour rather than compare it with what was an aberration when the Australian dollar got down to US48c or 47c. We should not use that as the basis for our comparison. We should compare it to the average.

If we look at the Australian dollar-US dollar rate for a start, basically the average is 56-and-a-bit at the moment. But the average over the 1990s was 72. Whilst we have come up from that exceptionally low point of last year, we are still nowhere near our average. You should use the average for last year if you want to use last year, which is nearly 52. So we have gone from 52 to 56, really, even though we did have a low point last year when it was 47. So it has gone up, but it is really, I think, at the moment just making up for the exceptionally low level it fell to last year.

The other thing, too, that we have to bear in mind is that we really should not be looking just at the Australian dollar and US dollar, because a lot of funny things that have happened over the last couple of years are really a story about the US dollar. I have often been asked to explain the behaviour of the Australian dollar and have said that, even though that is difficult to explain, it is even harder to explain what happened to the US dollar. So a lot of what we are seeing at the moment is simply the US dollar going down against every country in the world. So we are going up against the US dollar.

We are also going up in trade-weighted terms, but not as much. If you look at it in trade-weighted terms, first of all it means that the fall in the year 2000 and 2001 was not anywhere near as big as it looked to have been against the US dollar. The rise since then is not as big. For example, in trade-weighted terms, the 1990s average for the trade-weighted index is about 56. We are up to 53.3 at the moment. So we are closer to our average on trade-weighted terms than we are in US dollar terms. We are still way, way below our average in US dollar terms. Similarly, the average for the trade-weighted index last year was 49.6, and it is 53.3 now. So that is a better measure of how much the currency has come up.

Am I worried about it? No, I am not worried about it. I have a feeling, which you might have gathered, that I like things returning to normal. I feel more comfortable when things are returning to normal than when they are spearing off in one direction or another. I think that is what we are seeing happening with the exchange rate.

Mr PYNE—So you think it is achievable or at a more realistic level than it has been in past years, which is comforting to the Reserve Bank? It is at more realistic levels?

Mr Macfarlane—Yes, I do. It is always very difficult, when the exchange rate is at a level you think is a long way away from any reasonable measure of its equilibrium rate, to say that. People say, ‘Who are you to say that? The market has made its judgment and it says it should be—whatever it was—47.’ But now that it has actually come back some way and, more importantly, people not just here in Australia but around the world are looking at the US dollar and saying, ‘Why did it ever get so high,’ it has been coming down against everyone for three months or so. It seems to me to be a much healthier environment than we had to put up with in the last couple of years.

Mr PYNE—Do you have an optimal level that you think the Australian dollar should be at?

Mr Macfarlane—No. Other than that I said that I am always more comfortable when things are returning to their average than when they are spearing off.

CHAIR—That reminds me of a statement we heard recently from an economist saying that there are two groups of economists when it comes to predicting exchange rates: those who cannot do it and those who are yet to realise it.

Mr NAIRN—I have a further question on the Australian dollar. I accept what you say with respect to it getting back to some sort of normality. But some industries have, I guess, settled to some extent on that lower rate over the last couple of years to help them out of some previously difficult circumstances and are now about to face some fairly major challenges—particularly the rural industries with respect to things like US quotas, tariffs and the farm bill. When you add those sorts of challenges to some of those industries, does that give rise to some concern about a rising dollar at the same time?

Mr Macfarlane—There will always be differences between particular industries. Some are doing really well and some are not doing very well, and some feel that they would like to have the stimulus from the lower dollar. I have never heard anyone say they really need a higher dollar. The fact is that Australian exports over the decade of the 1990s managed to grow in volume terms of about seven per cent per annum, which is not quite but nearly twice as much as GDP. They did that with an exchange rate of 72c against the US dollar and 56 on a TWI. It is not as though we have to have the sort of stimulus of continually lower exchange rates to get our export industries to operate efficiently. They have operated very well over the last decade at exchange rates that are higher than it currently is.

Mr LATHAM—Mr Macfarlane, earlier in March you issued a press release about the exchange and government currency swaps dealing with an incident in the middle of 2000. Could you provide some more detail about when you first became aware of the plan of the Office of Financial Management to sell Australian dollars, the impact this might have on the currency and what you did about it thereafter?

Mr Macfarlane—What you are referring to is: when did I first become aware that the Australian dollar value of the US dollar loans was likely to exceed 15 per cent of the debt on issue? Therefore, the operators in the AOFM, if they followed this mechanical rule, would have to sell Australian dollars and buy US dollars. I think someone wrote a memo to me internally in the Reserve Bank in late May so I probably became aware of it in late May 2000.

Mr LATHAM—What did you do about it thereafter? What action was taken?

Mr Macfarlane—I spoke to the then Secretary of the Treasury next time I met him, which would have been in June.

Mr LATHAM—And what happened thereafter?

Mr Macfarlane—I think this is on the public record.

CHAIR—About a statement you issued.

Mr Macfarlane—I had better get my statement. I do not think I have got it with me. Basically, I spoke to him on several occasions. I said that I thought that the mechanical application of that rule would be detrimental to the macroeconomic performance of the Australian economy in that it would involve the government selling Australian dollars into a falling market, where the Australian dollar was reaching new lows every month. If it became known that the government was going to have to join in the rush and start selling Australian dollars, this would be very detrimental. In fact, it would be mechanical. The more they sold off and the lower the Australian dollar went, the more the Australian dollar valuation of the US debt would go up, the more debt they would then have to sell. So the thing would become self-reinforcing. I thought that this would be unhelpful for the macroeconomic interests of the Australian economy, which was already being penalised, I felt, by an unrealistically low dollar.

CHAIR—Would that not also be balanced by the holdings that the Reserve Bank has?

Mr Macfarlane—Yes. But that is not a major consideration.

Mr LATHAM—Mr Macfarlane, you spoke to the Secretary to the Treasury in June and expressed these concerns about the currency and stability of the Australian economy. But you did not write to the Secretary to the Treasury until 5 October. Why a four-month delay in actually writing and then further delays in the government taking action, given the seriousness of the matter?

Mr Macfarlane—The first thing is that you do not normally write. Normally when you are dealing with people, you talk to them on the phone or you talk to them when you meet them. In fact, if you wanted to be cynical, you would say that sometimes people only write when they want to have something on the record. If you just want to have an influence, you talk to people. I did that. Eventually, the Secretary of the Treasury was uneasy about overriding this rule, but I think he could see some merit in my argument. In the end, he said, ‘Righto. We’ll override it for two months as long as you write me a letter saying that that’s your advice and that I am acting on your advice, and I will override it for a couple of months. In the meantime, we will then take the subject up with the Treasurer.’

Mr LATHAM—Did you have conversations with the Treasurer during this period?

Mr Macfarlane—My first discussion with the Treasurer on this subject was at our regular board debrief meeting in early November. So I spoke to him in early November. I presented my point of view. He agreed with it.

Mr LATHAM—When did the Secretary to the Treasury first say he was taking the matter up with the Treasurer?

Mr Macfarlane—I have no idea when he spoke to the Treasurer about it.

Mr LATHAM—You just said a moment ago that in one of your discussions with the Secretary to the Treasury he intended to take the matter up with the Treasurer.

Mr Macfarlane—I did not say that. I do not know when the Secretary to the Treasury spoke to the Treasurer. All I can speak to is when I made my communications known. I spoke to the Secretary of the Treasury first in early June. I may have spoken to him two or three or four times in subsequent months. I wrote to him on 5 October. I first spoke to the Treasurer in—I could find the exact date if I wanted to—early November. I spoke to the Treasurer in the company of the Secretary of the Treasury. The three of us first spoke about it in early November. Then we had another meeting in early December, where we decided, or the Treasurer essentially decided, on my advice—I think the Secretary to the Treasury was comfortable with it by then—that we would not attempt to get back to the 15 per cent.

Attempting to get back to the 15 per cent would be counterproductive and destabilising. The Treasury or the Treasurer could override that 15 per cent whenever they wanted to. It was just a rule of thumb; it was not handed down chipped in stone. It was just a rule of thumb. They decided that they would override it subject to a thorough review of the policy over the next six months. A thorough review was undertaken. In the middle of 2001, a decision was made to gradually wind it down—in other words, to return the foreign currency exposure eventually to zero.

Mr LATHAM—Was it frustrating for you that it took six months from when you first raised the matter with the Treasury to have it resolved in December 2000, given the seriousness of it?

Mr Macfarlane—It would have been frustrating if during that period they had gone out and made sales of Australian dollars to buy US dollars to keep at the 15 per cent. But since they did not, since they accepted that that was not a wise thing to do—in other words, let it drift up over the 15 per cent—that did not worry me.

Mr GRIFFIN—I have one last question on that. The issue there is that it was four months.

CHAIR—Hang on. I will come back to you.

Dr SOUTHCOTT—Mr Macfarlane, I think you have already touched on this at the end of your last answer. Given the losses that have been talked about were unrealised losses, is it fair that the currency swap should be judged on a short-term basis?

Mr Macfarlane—No. They should not be judged on a short-term basis; that is correct. You should evaluate the policy over the life of the policy.

CHAIR—Mr Griffin has a question.

Mr PYNE—It is not possible to judge the policy in the short term, is it, Mr Macfarlane?

Mr Macfarlane—It is possible to have a successful policy which in some years will make profits and in some years makes losses. Therefore, it would be unfair to just concentrate on the years where the losses were made.

CHAIR—We will take one question from Mr Griffin and then we might take a break.

Mr GRIFFIN—In early June you raised it with the Secretary of the Treasury. You believe you raised it again with him several times in the following four months. Then at about that four-month time you wrote to confirm a request from him effectively to you to seek advice in writing?

Mr Macfarlane—He was feeling uncomfortable that this ratio was going over 15 per cent. He knew I was saying: just let it. He felt that he ought to have something on paper more than just his verbal agreement with me to be able to explain after the event why he had allowed it to go above 15 per cent. So that is when I wrote that letter.

Mr GRIFFIN—At his request.

Mr LATHAM—I have two more questions to finish up on this subject.

Mr GRIFFIN—I have a few questions on this subject too.

Mr LATHAM—We will come back to it.

CHAIR—We will come back to it afterwards, I think. We might take a short break because we have had a good hour and a half. We will have a cup of coffee and resume in 10 minutes.

Proceedings suspended from 11.31 a.m. to 11.52 a.m.

CHAIR—Did you want to add to an answer to that question, Mr Macfarlane?

Mr Macfarlane—Yes, I do. I think Mr Latham asked why did it appear that nothing much was done between June and October. I gave an answer in which I said that it was not all that urgent because the AOFM were not selling Australian dollars during that period. The case is even stronger. The reason they were not selling Australian dollars is because that ratio, which had briefly touched 15 per cent in May, went down again. It did not poke its nose above 15 per cent again until September. Mr Battellino has just reminded me of this because he has got the information. So in that period between about May and September—

Mr LATHAM—Which part of September?

Mr Macfarlane—I have only got a graph. I do not have the numbers here. Maybe it was even early September; I do not know when I received the memo. When I first raised it with the Secretary of the Treasury, for the following two or three months it then dipped down again. It was still somewhere near 15 per cent, so it was sort of an issue that you have discussed. But it was not actually something that was causing the AOFM to have to go out and sell Australian dollars.

Mr LATHAM—There are two things I cannot understand through this period from June to December, particularly now you have mentioned that it got to 15 per cent in September. Why did not the Reserve Bank just buy the Australian dollars off Treasury? Is it true that you did not because you did not have the necessary reserves at the time?

Mr Macfarlane—We had the reserves to do it but we thought it would be unwise given that our reserves were going down, that it would only be a very temporary solution. It was not a sensible medium-term solution.

Mr LATHAM—How far were they going down?

Mr Macfarlane—I cannot remember. It is all published. The stuff is published every month, so you can look it up.

Mr LATHAM—When this committee met with you on 1 December 2000, you said in your evidence to the committee that the bank had not been overanxious about the Australian dollar. You said that the Reserve Bank had been ‘quite sparing with its intervention’. Given that you had told the committee that at our hearing, why couldn’t you have intervened earlier on in the normal course of events to buy the Australian dollars off the Treasury?

Mr Macfarlane—Because it could have conceivably been open-ended. If the currency had kept going down, it would have meant just more and more use of reserves to do something which we did not think would be very productive.

Mr LATHAM—So you are saying the currency would have fallen so badly that you would not have had the reserves to defend it?

Mr Macfarlane—There is no cut-off point. All I am saying to you is that at that time reserves were going down. We were careful that we needed to husband them. The last thing we would want to get into was a potentially open-ended situation where every time the Australian dollar fell you had to go and buy something off the AOFM and use up reserves.

Mr LATHAM—If your reserves had been going up at quite an ample level, would you have embarked on the normal intervention strategy of buying the Australian dollars?

Mr Macfarlane—If reserves had not been going up at that time, that is because we would have been buying foreign currency.

Mr LATHAM—If you had been in a position to do so with the level of reserves, would you have embarked on the normal strategy of intervening and buying the Australian dollars off Treasury?

Mr Macfarlane—We did from time to time during that period buy Australian dollars off the market. We did not buy them off the AOFM. We bought them off the market because we were supporting the Australian dollar at various stages over the course of those two years. So there was a need for us to use what reserves we had and to keep some available for future use. We did not want to deplete them by doing this, which we regarded as quite unnecessary. That is why we did not want to go down that path.

Mr LATHAM—Basically, you wanted Treasury, in breaching the 15 per cent benchmark, to do the things that you could not do yourself, given the falling level of reserves?

Mr Macfarlane—We regarded, from our perspective, the 15 per cent as an entirely arbitrary number. It was the most sensible thing. It made a lot more sense to breach that than to put the Reserve Bank in a position where it felt it would have had insufficient reserves.

Mr LATHAM—Finally, Mr Macfarlane, I cannot understand why these matters have not been reported publicly, why you did not mention them at our hearing in December 2000. The chairman, Mr Hawker, specifically asked you about the sustainability of currency swaps. You raised no concern of any kind about the value of the dollar. You were further asked about intervention policies and why the bank had made no mention of these very worrying events of mid to late 2000. Further, this interaction between yourself and the government has not been reported in any annual reports of the Reserve Bank. Why the need to keep this so hidden from public view when you have a reputation for trying to build transparency?

Mr Macfarlane—I would have thought the answer to that was bleedingly obvious. I am sorry to use that term. If you are worried about your exchange rate going down, reaching new lows every month, you could not get out there in public and say, ‘I am worried. We haven’t got enough reserves. I am worried I’m going to have to do this. I’m worried about that.’ That is the last thing you would do.

Mr LATHAM—So you were worried about the Australian dollar when you told this committee on oath in December 2000 that you were not overanxious about the Australian dollar? If so, what is the point in having these hearings?

CHAIR—I think you have had an answer to that question.

Mr LATHAM—It is a serious matter. Evidence was given under oath. You do something at the beginning of the meeting that sounds serious. You said to us in December 2000 that you were not overanxious about the Australian dollar. Now you are saying you were worried and that is the reason why you did not say it.

Mr Macfarlane—I was worried about it, but I was not overanxious, Mark. Is that okay?

CHAIR—I think you got your answer, Mark. Christopher?

Mr PYNE—Mr Nairn had a follow-up question.

Mr NAIRN—I was just going to help on that. This currency swap thing, as I understand it, started back in 1988. Is that right, Governor? The Australian government commenced this back in 1988?

Mr Macfarlane—I believe so.

Mr NAIRN—So over that 14 years now the Reserve Bank has not operated any differently with respect to the government in the last couple of years as opposed to those last 12 to 14 years. Would that be the case?

Mr Macfarlane—Yes. That situation never arose. So it would not have really mattered. No. We did not do something in terms of our own operations. In terms of our own operations in terms of the way we from time to time intervene in the foreign exchange market, we have not changed our approach. The approach has been the same as it has always been.

Mr NAIRN—With respect to some of the criticism that has gone on in this debate about whether there have been losses or realised losses et cetera, to counter that, if the government was acting in such a way to supposedly counter the potential so-called losses, which are not realisable losses anyway, the government would have to enter into a situation where they would be effectively gambling, would they not, to overcome that?

Mr Macfarlane—I am not sure how to interpret that question.

Mr NAIRN—For instance, at the end of 1996-97, if you look at the cumulative effects of the cross-currency swap portfolio, theoretically there was an unrealisable profit of about $3 billion. To actually realise that, the government would have to get right out of it instantaneously. Surely that could be described as akin to gambling, because you are trying to pick the right time to get in and get out, which this particular strategy is really not about. It was over a long period of time.

Mr Macfarlane—I think you could always close down a policy if you wanted to. I do not think I would necessarily call it gambling if you just closed it down.

Mr NAIRN—But you could not realise it instantaneously.

Mr Macfarlane—No. It would probably take you a bit of time to do it.

Ms BURKE—Given that the Treasurer has now closed it down by saying that the policy is to end swaps, were you consulted on that? If you were consulted, what advice did you give? Leading on from that, do you think, therefore, that the government's debt management activities pose any further risk to the Australian dollar?

Mr Macfarlane—Our advice was to do what the Treasurer had decided to do. It was only advice. In fact, throughout this whole thing, anything that we did was only advice. We have no authority in this area at all. The Secretary of the Treasury or the Treasurer had every right to say, 'I've heard what you have to say, but I'm not interested.' So we never did anything other than give advice. Then the answer to the second one is that it is not going to happen instantly. But if we reach a situation where all our debt is denominated in Australian dollars, the currency composition of our debt cannot possibly have any effect on the exchange rate.

CHAIR—This is the last word, is it?

Mr PYNE—A lot of the members of the committee have concentrated on one year and another year. Just answer me this, Mr Macfarlane: is it not true that the reason the exposure increased reasonably dramatically was because of the heavy increase in debt prior to 1996, which therefore, because the 15 per cent was a proportion of that debt, increased our exposure quite dramatically? If the debt had not been increased before 1996, in fact our exposure itself would not have been increased?

Mr Macfarlane—This is a bit of a leading question, this one.

Mr PYNE—It is true, though, is it not?

Mr Macfarlane—Arithmetically it is correct. If you have 15 per cent of total debt, and total debt goes up, then the 15 per cent of it will go up too. Yes, that is correct.

CHAIR—We will move on. Mr Macfarlane, the whole question of interchange fees and credit card costs and so on has been something I am sure has been exercising some people's minds.

Mr LATHAM—I have some questions. Can we stick with inflation?

CHAIR—I thought we had finished with monetary policy.

Mr LATHAM—I mentioned it to you just before the break.

CHAIR—Go on, Mark. You have a question on inflation. Go for it.

Mr LATHAM—Mr Macfarlane, you said in your opening statement that the economy no longer needs the boost provided by an expansionary stance on monetary policy. Is this also true of fiscal policy at the current time?

Mr Macfarlane—Does it need a boost through a movement towards a more expansionary fiscal policy? Yes, it does not need a boost with a movement towards more expansionary fiscal policy.

Mr LATHAM—Are you disappointed, then, that the federal budget has gone into a $1.3 billion deficit for this financial year and the prospect of an uncertain figure for the coming financial year?

Mr Macfarlane—I think literally what is happening in the fiscal policy front is that, between the year we are in and next year, the budget envisages fiscal policy moving in a slightly contractionary direction from a small deficit to a small surplus.

Mr LATHAM—In our hearings last year you mentioned that you would be expecting substantial surpluses so long into the economic cycle and certainly warned against an auction in the run-up to the last election. We clearly had that auction, given that the forecast surplus of $14 billion for this financial year last became a $1.3 billion deficit. How much pressure has this placed on the upward movement of interest rates, given that the government's fiscal stance has moved against the advice you provided to us in May last year?

Mr Macfarlane—My general view on this is that the movements in the fiscal position these days are so small compared with what they used to be when I was first involved in this game in the 1970s and 1980s that fiscal policy had a negligible impact on our decisions about monetary policy. In fact, some of the movements that have occurred, probably more through good fortune than good management, have actually probably been slightly countercyclical anyhow. We did have a slowdown, if you average those two years 2000 and 2001. We certainly did face a big threat from the international economy of having a much bigger slowdown. So the fact that fiscal policy did move in a slightly expansionary direction did not complicate our job.

Ms BURKE—What do you think of the direction the budget is moving in?

Mr Macfarlane—Having said that the size of the movements in fiscal policy does not complicate the task of monetary policy, I do not feel I really need to comment on it any further than that. Yes, I am pleased that, given there was a deficit last year, the budget is projecting a surplus next year. Yes, that direction is probably right.

Mr LATHAM—Mr Macfarlane, could I just remind you that in May last year you told the committee that at the moment it would not be responsible to have a further major expansion of fiscal policy that pushed the budget into the red. Given that this is what has happened—a $14 billion run-down on the forecast and a budget that is now in deficit—what has changed between 11 May last year in your evidence to the committee and what you have said today?

Mr Macfarlane—I suppose the answer is that I do not think the deficit is a particularly large deficit. I do not follow these things as closely as some others, but my understanding is that it was not a discretionary decision to say, ‘Let’s run a deficit.’ It is just how the numbers ended up coming out. In fact, when the budget released the fact that their latest estimate for this fiscal year was a deficit, I think that was the first time that anyone knew it was a deficit. Is that correct?

Mr LATHAM—So you are trying to say all those spending decisions last year were not discretionary decisions?

Mr Macfarlane—We certainly knew that there were discretionary expenditure decisions occurring. But I do not think people knew it was actually going to be big enough to mean that the budget ended up as a deficit rather than a surplus. We certainly knew that whatever surplus was there was going to be declining.

Dr SOUTHCOTT—With the budget going from a deficit of $1.2 billion to a surplus of $2.1 billion and the Australian dollar appreciating against the US dollar and also against other currencies on a trade-weighted index, does that assist your role in the conduct of monetary policy?

Mr Macfarlane—Well, other things being equal, if you have an economy which is growing strongly and you are starting from a position of historically quite low interest rates, then you probably are looking for help from some things which might be slightly contractionary. If the budget outcome was to be the same as what is included in those numbers, it would at the margin be helpful. Similarly, the rise in the exchange rate, moving it back more towards normal levels, would also at the margin be helpful.

Dr SOUTHCOTT—Are the lag periods for fiscal policy and monetary policy of the same order in the same period? The period of maximal impact for monetary policy was previously set at about 12 months for maximum impact. Is it the same for fiscal policy as well?

Mr Macfarlane—My understanding is that, depending on the type of fiscal policy, its action can be quicker—the problem is that fiscal policy decisions take so long and the implementation can take so long. But once the actual change in spending or change in taxation occurs, the lag is quite short from that point onwards.

CHAIR—Have we have finished on monetary policy and inflation?

Mr LATHAM—I have two questions on inflation. Mr Macfarlane, there is something of a discrepancy between the Reserve Bank inflation forecasts and that of the Treasury, particularly in the medium-term outlook, where the Treasury has a more benign set of forecasts. How do you explain this difference? Which figure do you think your board member, Ken Henry, supports?

Mr Macfarlane—Everyone is smiling about the last sentence. I did not hear it. What was it?

Mr LATHAM—Which figure do you think your board member Ken Henry supports? Which set of forecasts—the Reserve Bank forecasts or the Treasury ones?

CHAIR—You have got to be a mind reader as well.

Mr LATHAM—He is a board member of yours, Dr Henry?

Mr Macfarlane—Oh, yes. The fact of the matter is that there is very little difference between those forecasts. The main difference is that ours are over a longer period than Treasury's. Treasury's forecast says 2.5 per cent in the year to June 2003 and ours says 2.5 per cent to the end of this calendar year rising to three per cent at the end of next calendar year, which is the end of 2003. So as we pass from the end of this year to the end of next year, we are probably going through at about 2.75. So we are really having a discussion over a quarter of a per cent. Of course, that is meaningless—a quarter of a per cent difference—a year away from where we are now. So I do not see them as being very different forecasts at all, particularly since, when you read the text of the Treasury's thing, they do identify a few risks to their forecasts. The risks they identify are in the upper direction.

Mr LATHAM—Finally, on page 54 of the May statement on monetary policy you talk about movements in inflation. I quote:

> Under gradual upward pressure reaching the top of the target by the end of 2003, the rise in oil prices, if sustained, will result in higher CPI inflation outcomes than this in the near term; that is, the inflation rate will be outside the Reserve Bank band and go above three per cent.

What is the worst-case scenario there? If those oil prices are sustained, what sort of figure can we expect as they go outside the target?

Mr Macfarlane—I am not sure that I know how to answer that. Malcolm, you are the guy who made the forecast. How about telling us.

Dr Edey—If oil prices stay where they are now, they will add to the next CPI result and flow through into petrol prices at the pump. Roughly speaking, that will add about 0.4 or 0.5 per cent to the inflation rate over the next year. So that is the main driver of differences between the underlying rate and the headline CPI forecast.

Mr LATHAM—So 3.25, 3.5? What are we looking at?

Mr Macfarlane—It would be something like 3.25 or maybe 3.5.

Mr LATHAM—How long do you think it will stay outside the band?

Dr Edey—The forecast really has some shape in it, so it is actually coming down in underlying terms in the near term. If you add the petrol price effect back on to that, you are going to end up with numbers of around about three during the year or may be slightly lower than that. So it is really next year that you start to get any tendency for inflation to get above the target.

CHAIR—Any further questions on this aspect? We might move to the credit card question. In your December report, you made some comments. There will be another paper to be released, I think, soon on this. I am wondering, since we are here today, whether you might give us a bit of an insight into the Reserve's thinking and how it has changed from that December paper, given that we have had consultations with many of the players in the industry?

Mr Macfarlane—We have had a lot of consultations. I suppose all I can say is that in the most recent set of consultations some of the arguments that are being put forward to us are different than in the earlier set of consultations that occurred last year. In other words, some things which attracted a lot of attention in the early stages—the financial institutions and the card schemes—are not pushing. There are some other newer ideas which have come up in the second round which were not there in the first round.

My general feeling is that some of the things that we suggested were thought to be quite shocking by the financial institutions. Not all of them have necessarily accepted, but a significant number of financial institutions have accepted, that some of the things they originally thought were shocking are now not that unreasonable at all. We are evolving towards an outcome; there is no doubt about that. Our next paper is actually going to be the outcome. It is not another discussion paper. It is going to say, 'As a result of all these deliberations, these are the changes that are going to be made.' I think the process has actually been quite educative for everyone who is concerned. By the time that happens, the differences between the parties will be smaller than when we started.

CHAIR—Will you address the concerns raised by the open letter written by some of the regional banks—the Adelaide Bank, the Bank of Queensland, the Bank of Western Australia, Bendigo, St George, Suncorp Metway—where they made quite an interesting point. They said that smaller banks compete with the majors to provide credit cards but do not enjoy the same economies of scale. As a result, proposed changes to the credit card systems will clearly impact most on the ability of smaller players to offer competitive products. Will you be able to accommodate those concerns?

Mr Macfarlane—Can I say for a start that the ABA put that open letter in the newspaper because they sent a copy to us beforehand and said that they would put it from the regional banks. So it is really the ABA talking, not specifically the regional banks; that is the first point.

The second point is that it is an argument which has come up from time to time which has been applied to more than the regional banks. It says that competition is a good thing and we want to have competition. How do we define competition? We want to have more numbers. How do we get more numbers? Let us make sure the price is very high. Then we have got this wonderful thing called competition. But competition is actually meant to drive prices down. It is really getting the cart before the horse to say that we have to make the prices high so that we can have more people and that will be called competition. That is actually the opposite outcome of what competition does and is meant to do, which is to reduce the price to the ultimate users of the product.

CHAIR—I accept that point. But we know from experience in many other areas that, if it is just straight competition, then the majors or the major cities or whatever will always be seen as the most economical ways of getting prices down, whereas the regions and some of the regional banks, presumably in this case, could well be squeezed out even though the competition may benefit people, in this case, in major banks.

Mr Macfarlane—In the case of credit card issuing and credit card acquiring, the share of the market which is controlled by the major banks in those particular activities is higher than their share of ordinary banking business. So I think that is correct. I stand to be corrected, but I think it is correct. In other words, this particular activity—credit card issuing and acquiring—is already an area where the majors dominate much more so than they dominate banking in general. That is the first point.

The second point is that, even with the existence of some small players, it has not had a competitive pressure on the crucial prices in the system. One of the reasons we got into this is that the crucial price in the system, which is the interchange fee, has effectively not changed since 1974. So the existence of what is actually a very small fringe of non-major players has not had any impact in reducing costs to customers.

Mr GRIFFIN—Mr Macfarlane, just to take up the point about the fact that the fee has not changed over that period, there are some allegations around the traps that essentially there has been some sort of price fix involved with respect to that. Is that the view of the RBA, or do you see it as a situation of just basic market failure?

Mr Macfarlane—I think price fixing has a sort of specific legal implication, which I do not particularly want to get into. We have never actually said that. All we have said is that the key price in the system is collectively set. It is sort of collectively set because that is the nature of the way the system operates. So all we have ever said is that it is collectively set. We have not used the term ‘price fixing’.

Mr GRIFFIN—When you look at the question of where you are from here in terms of some time after the end of June coming down with a final position, I have two questions. First, where do you think you will be up to with the issue of debit cards with respect to that being part of the overall system, as I see it? From that, what is your position with respect to the closed schemes, Amex and Diners?

Mr Macfarlane—One of the other good things that has happened since we have started this process with credit cards is that it has forced the people in the industry to look widely not only at credit cards but at debit cards and ATMs. The system we have here is actually basically a historical accident. No-one sat down and designed it properly. These various instruments came on or were invented at different times. The credit card, of course, is quite an old instrument. The ATM is a more modern instrument. The debit card is a more modern instrument. The three networks are all different. In fact, they do not even sit together very logically. Since we have been doing this work on credit cards, which has been forcing the banks principally and the credit card schemes to do a lot of thinking about it, they have started to re-examine their views on debit cards and ATMs, even without us designating either of those two streams. In the case of ATMs we have had a series of meetings, which the Reserve Bank has been present at, to see whether there is a better and more transparent way of pricing ATMs. The same sort of process is starting to work with debit cards.

Your second question was about the three-party credit card schemes, by which we mean Amex and Diners. We believe that the biggest impact on them will come from the fact that merchants will be able to pass on their costs to customers. At the moment, as you are probably aware, Amex and Diners are more expensive for merchants to accept than the four-party schemes. In some countries—in fact, even here—they are much less acceptable. There are a lot of merchants who just will not accept them because they are too expensive.

So we believe that when the interchange fee and the merchant service fee for the four-party schemes go down, the fact that the three-party schemes are still very high will become even more apparent to merchants. By then, they will have the newfound power—the power they should always have had—to pass on that cost. If their customers want to use this very expensive payments instrument, then they can pass that cost on to them. If the customer wants to use a cheap payments instrument, they do not pass it on. We think the discipline in the system will be that capacity for merchants to pass on the costs that they have incurred by you using a very expensive payments instrument.

Mr GRIFFIN—So you do not see any need to take action yourself? You see it as being a situation where the market will correct it?

Mr Macfarlane—I am not sure exactly what the state of affairs is at the moment. But we have said to them that they should voluntarily fall into line and withdraw this prohibition which they currently impose on their merchants voluntarily. If they do not do it voluntarily, we will designate the system and do it. We think it is probably easier if they do it voluntarily.

Mr GRIFFIN—In terms of your original point about debit cards, where are you up to with those?

Mr Macfarlane—We do not have an active program going on debit cards at the moment. That was always going to be the next cab off the rank. But, as I said, the banks themselves are talking about changing debit cards. You might be aware that, even though debit cards are much cheaper for a merchant to accept than credit cards, debit cards do have a small interchange fee. It is a flat fee; it is not a percentage of the purchase; that is why they are a lot cheaper. But that fee actually goes from the card issuing bank to the merchant's bank, which is the opposite direction to which it goes in every other country in the world. That is evidence yet again that these arrangements in this particular part of the retail payments system are very largely arbitrary and historically determined. People are starting to realise that; the participants are starting to realise that and are starting to ask themselves questions like 'Should it go in that direction? Should there even be one at all?'

Mr GRIFFIN—Are you confident now, given from what you have said earlier on—that you have noted a change in attitude or at least in information exchange over the last couple of months with respect to the various players in this field—that in those discussions you have now been able to get all the information you do need to be able to make a decision or to finalise the matter?

Mr Macfarlane—I do not think there has ever been anywhere in the world an examination as thorough as the one that we have conducted here. The financial institutions by and large have been very cooperative and have made a lot of internal information available to us as long as we respect the firm-specific information and only ever publish averages of all firms. I think so, yes. I think we have all the information we need.

Mr GRIFFIN—I have one last question. On the issue of no surcharge being abolished and the question of what that rate of surcharge might be, I know that the experience internationally where this has been abolished is that in most cases merchants do not tend to charge. The concern that has been raised with me is the issue of rural and regional areas. That may be the place, if anywhere, where in fact charging does come in and where there may be a market problem with respect to that. Have you considered that issue? How do you consider the handling of that issue on a competition basis? My understanding as to where that is up to is that there has been no ceiling talked about in terms of what a surcharge might be. I thought you might like to comment on that.

Mr Macfarlane—The general feeling from the people we have spoken to, both in the financial sector and in the retail sector, is that, for the majority of transactions that people do at the supermarket or what have you, it is very unlikely that retailers will pass the fee on to the customer. But for very big ticket items, if you were buying something for $2,000, it could cost the merchant $40 if you pulled out your credit card while it could cost the merchant a matter of cents if you pull out your debit card. If that is the case, some of the merchants, on those very big items, will be prepared to do it. But for the vast majority of transactions—95 per cent of transactions—it is unlikely to occur. But it is still enough to provide a discipline in the big transactions.

The argument about the regional one is a bit demeaning to people in the regions. It seems to be saying that merchants in the regions will be much more rapacious than merchants in the city and that they will rip off their local townspeople or be much more willing to pass on this fee to the local people in the town than the merchants in the city would. I just do not think that is really likely at all. I do not see why they would be more willing.

Mr GRIFFIN—When there is a lack of competition, the temptation to fully pass on costs to an even greater extent is likely.

Mr Macfarlane—The first thing you have to consider is that people are paying at the moment. They are paying in the price of their goods. Under this system, you will not have to pay it in the price of goods. If you wanted to use an expensive payments mechanism, yes, you might have to pay for that. But if you do not like to use an expensive payments mechanism, well, use a less expensive payments mechanism. That is the way the market is meant to work. If something is very expensive, you move to a substitute which is less expensive. Unless you have this model in your mind where there is this regional town where there is only one store and somehow or other the store keeper in that one store is going to be particularly tough compared with what would happen in towns where there are two or three stores, I do not see any reason to believe that the merchants in the regional areas would be any different from the merchants in the city.

CHAIR—On this setting of the interchange fee, in your opening remarks you mentioned that in your December discussion paper one of the things you wanted to see was a new and transparent standard for setting interchange fees on credit cards and so on. That presumably is still going to be one that will have to be set by the payments system board.

Mr Macfarlane—The aim is to establish a standard which says that these costs can be included. Then the actual mechanical setting of it is something which we have not really quite decided yet. We could do it. We could hire an accounting firm or something to do it. But we want to actually make it at arm’s length to the actual participants in the card schemes. For it to have credibility, it is better that someone else does it.

CHAIR—The follow-up question is that with something that, say, the ACCC arbitrates on there is always the right of appeal through the Australian Competition Tribunal. That adds, I suppose, a new development, for the payment system. There is no right of appeal at this stage. Does that concern you, and should we be taking steps to address that?

Mr Macfarlane—No, it does not really concern me. As I say, I think we have done the most thorough and public examination of this subject that has ever been done anywhere in the world. If you were to have an appeal process, presumably you would have to be expecting someone to be doing an even more thorough and detailed examination than we have done, and I cannot conceive how it would be possible or how long it would take. The process has already been going on for over two years.

Everyone has had their opportunity to present their point of view. They certainly have both privately to us and publicly.

CHAIR—That is something the committee will have to continue to monitor. Are there any other questions on this? We might move on to other issues.

Ms BURKE—I have something totally different. I am interested in going to the annual report. You seem to have gone into a great deal of explanation for the first time about your shift from Commonwealth government security holdings to repos. Given the current Treasurer's obsession with debt reduction, does this actually have some negative impact for monetary policy overall, given that there are no CGSs about any more because there is no debt to service, and given his outright obsession now to completely get rid of debt as opposed to bringing it down to a manageable level? I was interested that you went into such great length. Do you have some comments on that to make?

Mr Macfarlane—We have traditionally conducted our market operations in government securities. We used to do it outright buying and selling them. We now mainly do repos on government securities. It used to be only Commonwealth. Then we decided no, we could do it on state borrowing authority debt as well as Commonwealth debt. I think our view is that, if we were ever to reach the point where there was not enough Commonwealth or state authority debt around, we could probably find a way of conducting our market operations using private sector instruments. It is certainly true that it is much easier with government securities. But it is not an insoluble problem, I would think. We have not really reached the point of actually making any judgment on that at the moment. Do you want to add anything on that?

Mr Battellino—No. Basically, we could use any range of securities. We use Commonwealth securities because of the convenience. But anything else I think we could cope with, really.

Ms BURKE—Projecting into the future, you have not thought if there is no doubt around, which is the Treasurer's view, that you have not looked and said, this is where we are going to head in the future direction?

Mr Battellino—For the next little while, I do not think anybody is envisaging much change in the amount of debt on issue for the next year or so at least. So it is not an immediate issue for us.

Ms BURKE—Another thing in the annual report is the financial system's stability. You go into some obvious just great length about the economy being okay. But one blot on it was obviously in the insurance industry and the wonderful collapse of HIH. Given APRA's complete and utter failure to do anything about that, do you have concerns about APRA's ongoing roles? You also make some comments about banks and financial risks and not being a run. Do you still have concern that the RBA has lost its power to actually monitor the banks? I know you are on the board of APRA.

Do you have any ongoing concern about that and where that will head post the outcome of the HIH inquiry?

Mr Macfarlane—I suppose events that have happened have taught everyone a lot. We are all learning a huge amount from this royal commission. I hope everyone is reading that, because it is quite amazing the stuff that is coming out. If we turn the clock back to when the Wallis inquiry was being conducted, most of the Wallis discussions were really about banks and how you supervise banks and who should do it. Banking was at the time considered to be, I suppose, implicitly the area of most concern.

Since APRA has been formed, it is probably true to say that they hardly have to spend any time on banks. Their workload has been dominated not just by that insurance company, although that is a huge event, but also by several other reinsurance companies and things in that area. So it teaches us that it is hard to plan ahead. The shocks come from somewhere where you did not expect them. That has certainly been the case for APRA.

The other thing I would like to say in APRA's defence is that it is an amalgam of three separate institutions. It is the bank supervision department of the Reserve Bank; it is the Insurance and Superannuation Commission in Canberra; and it is AFIC, which was the body that supervised the building societies and credit unions. It was a very difficult task to put those three together. They all had very different cultures. They were located in different parts of Australia. It was a massive management job to try to put them together.

Of course, it was very unfortunate for APRA that when the shock hit it—actually hit the bit of APRA which was really the remains of the old Insurance and Superannuation Commission—they had been with APRA for such little time that really the culture had not had time to change. APRA was in some sense unfortunate that that event occurred on their watch. From what we now know from the royal commission, it was going to happen. Whoever happened to be responsible for supervision of insurance at that time was going to end up with a lot of egg on their face. It was very unfortunate for APRA that it had barely been formed; it had really been going for about a year and a half. Management were still involved in these massive management problems when this huge event occurred. I think it would be most unfair to judge APRA as an institution or to judge its future value to the Australian economy on that one event.

Ms BURKE—Do you think they are improving?

Mr Macfarlane—Yes. One of the problems, as I might have spoken of before, is that even though banking regulations had been changed on numerous occasions to bring it up to date, life insurance regulations have been changed and superannuation had been changed. General insurance, which is where FAI and HIH operated, was still operating under the same act that was written in 1975 and had never been updated. So it was, in some sense, we now know with the benefit of hindsight, the weak link in the supervision framework in Australia.

Ms BURKE—Do you think the insurance industry is actually learning some lessons and going to pick up their game? You were a bit critical last time about them being less willing to assist APRA in change than the banking industry had been, with your experience with the Reserve Bank.

Mr Macfarlane—I think that is one of the results that occurred. In the early days, the insurance industry and their lobby group were really quite uncooperative. After HIH collapsed and we learnt about it, the insurance industry has recognised the weaknesses in some parts of their industry and have been very cooperative.

Ms BURKE—I have a final quick question. In the annual report, there was mention of a global committee on accountancy standards. Again, that came out of HIH and Enron. Have we seen some movement in ensuring that accountancy firms are actually adopting standard practices and ones that are legal and are being implemented so that, if somebody does an audit of a book, we as consumers can trust those numbers that we are provided with?

Mr Macfarlane—Accounting standards are at the heart of the Enron thing. The thing that frightens everyone is that, when all the investigations are complete on Enron, we might discover that Enron did not break any rules; in other words, the rules were so bad that you could adhere to them and still do what Enron did. I do not think that in the HIH case accounting standards are at the centre of the issue. We certainly do know from the royal commission that there were financial reinsurance contracts which were incorrectly accounted for as reinsurance when they should have been accounted for as loans. But I do not think that was a deficiency in our accounting standards. I am not sure whether this issue is sub judice or not, but I do not think it was the accounting standards that were at fault there. There was a deliberate plan to use the wrong accounting standard.

Internationally, accounting standards are a big subject. There is a tug of war going on between the United States and the rest of the world in which, from my reading of the situation, the United States is now starting to concede that their black-letter law approach to accounting is not the way forward—that the international accounting board’s standards, which are much simpler and smaller, are the way forward. On Enron, the particular bit of the accounting standards that were abused was the use of these off balance sheet entities as if they were independent of Enron. I am told that the particular standard that deals with that in the American system is 803 pages long. The summary at the front of it is 71 pages single spaced for one standard. With this approach, no matter what you specify, eventually someone will find something you did not specify. That is basically what has happened in the Enron case. So accounting standards are certainly a big subject around the world. They are less so here. They are not at the centre of our problem the way they were in the US.

CHAIR—I would like to follow up on a couple of points that Ms Burke raised there. I will quote from a lecture given by Howard Davies, whom I am sure you know, who is the chairman of the Financial Services Authority in United Kingdom. In a paper in January this year, he talked about trends in insurance which are causing anxiety. In particular, one of them he raised was insurance-based investment banking. He said:

> We have seen a rapid growth in credit risk transfer of various forms between the banking or investment banking sectors and insurers or reinsurers. More recently these transfers have taken more exotic forms such as collateralised debt obligations (CDOs) or indeed synthetic CDOs. One investment banker recently described synthetic CDOs to me as "the most toxic element of the financial markets today".

He went on to talk about the reasons. In particular, he talked about the regulatory reasons for risk shifting across sectors, which he said would be of interest to the Financial Services Authority. He said that if there were curiosities about the relationship between the capital regimes for banks and insurance companies which are driving this risk transfer, then we may be creating, not reducing, market instability.

I notice this was also mentioned in the *Economist* this month on 18 May. They talked about the same thing. They raised the question of millions of dollars are being made in fees and dealing spreads by simply repackaging debt. My question to you is this: first of all, are you aware of the growing use of these CDOs, or collateralised debt, and, second, are you doing some work to look at any effect this could have on the financial stability of the banking sector?

Mr Macfarlane—The answer to the first one is yes, we definitely are aware of it. It is something that APRA has spent quite a lot of time on. As a board member of APRA, I have read some papers that they have prepared on APRA's guidelines towards the use of these things which are, to use the shorthand term, what we call credit derivatives. The origin of it was that banks by their nature have to take a lot of credit risk. They would like to get rid of some of this credit risk in order to diversify their risk, or take some other type of risk. So they have found ways of packaging, securitising, lots of little loans together with lots of separate credit risks in them and selling these loans to someone else, who wants to take some credit risk because they have a different sort of risk.

Basically, what has been happening is that a lot of banks have been securitising lots of small loans into big parcels and selling them in the open market. The main buyers, as Howard Davies, points out, have been insurance companies. There is a fear around the world that some of the insurance companies are quite unsophisticated in understanding credit risk. They may end up taking on a lot more risk than they think they are taking on.

I think it is entirely reasonable that regulators are a bit worried about this and they want to make sure that they know what is happening. In Australia, there are credit derivatives. Banks use credit derivatives, but on a much smaller scale to what is used, particularly in the US. APRA has guidelines and has statistics on how much credit derivatives have been sold into the market in Australia. Ultimately, it becomes a system stability issue. The vulnerability is not from who sold the credit derivatives but from who bought the credit derivatives. Again, because APRA is a unified regulator, if it thinks there is an undue concentration of risk in insurance companies, it can follow that up. It is in a much better position to do that now than it was before the insurance supervision arrangements were changed.

CHAIR—Does the Reserve have an involvement here as well?

Mr Macfarlane—We pay attention to it. We have read these papers. But we do not have a direct role. If you thought something was going wrong or there was an undue concentration of risk, the appropriate regulatory response would be to put some rules on where the concentration of risk was building up, which would conceivably be in the insurance industry. You would also have to have very clear rules on how other banks do securitise these things.

Markets are becoming incredibly complicated. Risk transfers are becoming more and more sophisticated. Financial markets are growing faster than other parts of the economy. I am glad you raised the subject because, having seen what happened with HIH, I think a modern sophisticated society like Australia has to have supervisors who can keep up with what is happening. That cannot be done on the cheap.

Dr SOUTHCOTT—I wanted to go back to the questions along the lines of the declining supply of Commonwealth government securities. All things being equal, does having a budget in surplus put less pressure on interest rates, from your point of view?

Mr Macfarlane—Well, when I have had to answer this one in the past, I have always said that the relationship between fiscal and monetary policy is not a close one. The movement in fiscal policy, whether it is towards surplus or deficit, has to be sufficiently large to actually have a measurable impact on the economy before we have to take it into account. In other words, if you moved towards surplus in a very big way, it would have to have meant that you either cut expenditure or raise taxes, and that would have a contractionary effect on the economy. We would have to take into account the contractionary effect on the economy in setting our monetary policy. Similarly, if you move towards a deficit, it could have an expansionary effect. The mere fact of whether the number has got a plus or a minus in front of it is, in my view, not all that important, if the number is a small one.

Dr SOUTHCOTT—Okay. I will continue with that. In the United States, the chairman of the Federal Reserve has said a number of times that adopting a deficit reduction strategy has allowed interest rates to have been much lower than they otherwise would be.

Mr Macfarlane—I think he was referring to a very big reduction from a very big budget deficit down to a surplus, which occurred in the second half of the Clinton administration. That would probably fit into the category of what I would call a very big reduction. As I said, if it was big enough, it would have an impact. In an economy which is relatively stable, where there are not big swings in activity, and with reasonably responsible fiscal policy, you would expect that the size of the number, be it deficit or surplus, would be relatively small.

Dr SOUTHCOTT—If the Commonwealth government is running budget surpluses, is not the best thing to do to repay debt?

Mr Macfarlane—Yes, it probably is the best thing to do. There are not many alternatives. You have to either repay debt or buy an asset of some form. If you ask at the end of the day which of the two makes the most sense, I think it is to repay debt. If you run a surplus and instead of repaying your debt you buy an asset, people will start asking, 'Why are you taking all these taxes off me just to buy some assets?' I make one exception to that rule. If you have already got a debt, which maybe is a debt that does not figure directly into the budgetary processes, there can be an argument for buying an asset which is designed specifically to be the counterpart of that debt. I do not want to pronounce on this, because I have not thought enough about it at the moment, but there is an argument in this country that says that if the government runs a lot of surpluses and it has actually got an unfunded liability for its own employees' superannuation, there could be a logic to match that unfunded liability with some assets. One could imagine those sorts of circumstances, where the acquisition of assets was specifically designed to be the offset to an existing liability—that one could use that approach.

Dr SOUTHCOTT—That is a special case example, because I would not want the government actually buying assets because it has an impact on assets price inflation.

Mr Macfarlane—You would not want it to buy assets if it had no need to buy them. Some countries actually do that, but they do it for a very strategic reason. For example, Saudi Arabia did it because the government had massive revenues. So it bought assets. Singapore does that regularly. Singapore has always regarded itself as being vulnerable in a geopolitical sense. Its government runs surpluses every year. The surpluses go into a fund, which is effectively like a massive provident fund invested offshore for the citizens of Singapore. One can imagine special circumstances where you might want to do it, but it is not normal.

Dr SOUTHCOTT—Is it true by international standards, OECD standards, that we have a very low level of government debt now? That would also reduce the amount of interest repayments that governments would be making.

CHAIR—It is not question time.

Ms GAMBARO—I return to your opening statement when you were talking about the ABS capex survey and business investment. The newfound confidence that has occurred—why has it taken so long? We have had interest rates at a fairly low rate. Is it because the global international global outlook is looking much better? Why has business been very slow to invest in capital investment?

Mr Macfarlane—It is a very good question. I am not sure that I can give a really full answer to it, but I will make a few observations. The first thing is that you are right to say that business investment over the previous couple of years has been sort of sluggish, considering the way the rest of the economy has performed. I do not know the exact figures, but certainly it has fallen as a proportion of GDP. That is the first observation.

The second observation is that that may have been actually in the long run no bad thing, because the economy grew very well without a big stimulus coming from business investment. But the stimulus, we believe quite strongly, is about to come. So really I am only restating in some sense the facts that you have presented to me.

You are asking why there was that reluctance to invest on a big scale. I can only assume that it was related to the widespread perception, particularly during the year 2000 and still during the year 2001, that Australia was some sort of old economy and exciting things were not happening here; all the excitement was going to be in the United States or Europe. It was this perception that was one of the major reasons why our exchange rate fell so much in 2000. You can see it in all the official figures. You can see that during that year 2000 inward portfolio investment into Australia virtually dried up; no-one wanted to invest here. We had gone out of favour. It has resumed now.

So I can explain it, I think, in terms of this business perception at that time. We had just been through the Asia crisis. We were not a great place to invest in. But that perception has changed. You can see it in the portfolio capital inflow that has resumed. You can see it in the investment intentions in the capex survey.

Ms GAMBARO—I have a follow-on question. On the increased rate of business investment, would you like to comment on what the rate of unemployment is like? Can you link it through with that and say that, now there is this newfound confidence, some of it will shift from the housing sector into other sectors and goods and services will increase and perhaps our unemployment figure might drop slightly?

Mr Macfarlane—I do not want to make a forecast, but I think the unemployment rate will come down. At the very least, we would all be very disappointed if it does not get down below six. I think we would have to assume that it will go down below that and that it will be in the fives.

Ms GAMBARO—So these conditions would set a good environment for that to happen, or would help it?

Mr Macfarlane—That is what the conventional forecast at the moment would be, that the expansion will continue and that the unemployment rate will go down into the fives.

Mr LATHAM—Mr Macfarlane, in your speech at Melbourne on 4 April, you mentioned the need for substantial higher education reform in Australia. Since we are gathered here at Australia’s oldest and greatest university, I thought I would ask whether you have been able to further research this suggestion and come up with some specific policy proposals?

Mr Macfarlane—I am sorry to disappoint you. I will not be able to do that. That speech was about Australia's prospects. When I wrote it, I realised that everything I was saying was very favourable. As I got to the end of it, I thought, this sounds likes a Pollyanna performance. There have to be a lot of things that are wrong that need improvement. So I started writing down a number of them. I thought, 'This is going to be a ridiculous list—a whole lot of things and not having much to say on them.' I thought I would pick one. I thought, 'What is an area where I think our performance should make us very unhappy in an international comparison?'

As I was thinking about that, Professor Alan Gilbert, who is the vice-chancellor of Melbourne University, said that he did not believe there was an Australian university in the top 100 in the world. I was absolutely shocked when I heard that. I am not sure whether he is right or wrong. I assume that he is probably right, because he knows a lot more about the subject than I do. By the way, before I go any further, that does not mean we do not have faculties in top 100. Individual faculties in individual universities would certainly do that. But he felt that for a university as a whole we did not.

I thought, 'In what other area of endeavour would we be able to listen to that and not get upset about it?' If we said that we did not have a golfer or a swimmer or a tennis player in the top 100, we would be very embarrassed about that. A lot of industries, if we said we did not have a company in the top 100, would be very embarrassed about it. Yet with his comments, did people listen to them? I would have thought they would have made headlines. It made me feel that there was a feeling of great complacency that had crept in about higher education. That is why I thought I would raise that.

But I do not profess to be a person who has any great knowledge of the subject. There are a couple of areas of education I know something about, but the vast majority of it I do not know. I did something I do not normally do and stuck my neck outside my area of expertise. But the main purpose of it was just to reflect on how it is possible that he could say that and people were not aghast that it was taken in our stride, as though we have come to accept that. That was really the point of my comment.

Mr PYNE—In your opening statement, you commented that the debate is no longer about whether there will be a recovery but about whether it will be an average or below average recovery. Does the Reserve Bank have a view on whether it will be an average or below average recovery?

Mr Macfarlane—In the world economy? My guess is that it will be below average. The important thing to recognise is that we have got one and it has started. When we look around the world we can see that there was positive growth in the first quarter of 2002 where there was probably negative growth in the second half of the year 2001. So we have got a recovery. It has started. Is it going to totally peter out? I do not think so. I think it is going to go ahead. But I think it will probably be below average compared with earlier ones—for several reasons, one of which is that the international recession was much milder.

Some of the things that normally occur in a recession which push it down and make it deep but then allow it to bounce back have not occurred. For example, in the US, normally in a recession, the housing industry collapses. Then in a recovery it picks up. But in the US, the housing industry continued strong throughout.

Consumption is the same. Automobile purchase is another. A lot of things pertaining to the household sector did not really fall, so they have not got a low level to recover from. For those reasons, I think it will be a reasonable recovery. But if you go back and look at the historical records, you discover that in a lot of cases the first year of recovery is a very sharp bounce back. We do not see it being a very sharp bounce back.

Mr PYNE—The other thing in your opening statement that you commented on was the question of how the political situation in the Middle East and the Indian subcontinent might affect the world economy. Given that September 11, while it did have an effect on the world economy, did not have quite the substantial effect that many people thought it would have and did not do quite the economic damage that was anticipated, and given that the Middle East has been a difficulty for a long time and a great difficulty in recent years, not just recent weeks or months, how serious do you really think a war in the subcontinent would be in terms of the world economy?

Mr Macfarlane—I think your comments about September 11 are correct; I think it was a major geopolitical event but a minor economic event. I think that is correct. I cannot really speculate. But instead of it being a terrorist attack, which is what September 11 was, but a full-scale war between the second biggest country in the world and the 10th biggest country, or something, I imagine—for instance, if we are talking about India and Pakistan—that it would have an impact. With the Middle East, you always think that the transmission mechanism would be through the price of oil. But I cannot say any more than that other than to say that there are some risks out there. Everyone just concentrates on the US economy now. It is amazing how much of international coverage of economic matters is really just coverage of the US. We all know so much about the US. I just wanted to spread it a little wider than the US.

Mr PYNE—With respect to the Middle East, I think you can see how the price of oil could have a substantial effect on the economy of the world. But Pakistan and India, while they have large populations, are not major economic powerhouses. I wondered whether that would have a substantial impact or whether it would be a bit of a blip.

Mr Macfarlane—The other thing, I suppose, is that you often hear of safe havens buying and what have you. It is conceivable that some conflicts would actually almost be beneficial to Australia because we are a safe haven. So it would be very difficult to work out. It will not have any direct effect on us, but it could have an effect on the world economy. Then the world economy would have an effect on us.

Ms BURKE—Do you think the RBA gives sufficient attention to the employment consideration in its charter when it makes monetary policy decisions, or do you think inflation always dominates?

Mr Macfarlane—My answers to the question are firstly we do take our employment obligation very strongly and the particular way we go about doing that in my view is our emphasis on the sustainability of an expansion. It is the length that matters. You have got to keep it going rather than trying to achieve a growth rate in any given year. The second thing I would mention is that, even though you give equal weight, the reason it appears that you are giving more weight to inflation than to unemployment is that you have a number attached to inflation, and there is a good reason which I won't go through in great length. But I think you understand why it makes sense in the long run to put a number on it. On unemployment, you do not actually put a number, even though your aspiration is to get it down. It would take 10 minutes to explain that, and I will not go through it. The fact that you put the number on inflation and that you do not put the number on the target for unemployment does not mean that you are not interested in getting the unemployment down. You are very much interested in getting it down. You think that the best way of getting it down is to have a long expansion. The only way you can have a long expansion is for it to be a low inflation one. That is why you put the number on inflation.

Ms BURKE—Was not that contrary to what we actually saw insofar as in the last couple of hearings we were talking about the fact that we had a terrific growth rate but we did not actually have a reduction in unemployment, and we are still seeing that, as Teresa’s questions were getting at? We still have not actually had any flowthrough of benefit from economic growth in employment outcomes?

Mr Macfarlane—With monetary policy, the way monetary policy can contribute to a lower unemployment rate and higher employment growth is through the economy growing. We cannot do any more than that with monetary policy. The unemployment rate did go up and there was a pause. As I said in my introductory comments, we did not get through this world recession scot-free. We did have a slowdown. The slowdown this time was enough to push the unemployment rate up by only one per cent. In the past, we have had recessions and they have pushed them up by 4.5 or five per cent. So this time it went up by one per cent. It was short lived. It is back down again to 6.3. This was the benefit of keeping the expansion going. It does not mean you can immunise the labour market completely, but you can minimise the effects on the labour market.

Ms BURKE—I am going to change the topic completely because I am about to leave. Just looking at your earnings, which are very impressive, you have gone from $2.1 million to $5.4 million but you have also lost a whack of your actual banking services. Where have the profits come from? Are you charging exorbitant fees and charges like the other major banks out there? Where has your growth come from?

Mr Macfarlane—This is definitely the one to answer off the top of my head. We provide banking services, but there is only one state that we provide banking services to now. We still provide banking services to the Commonwealth. We have very big customers there, particularly Centrelink and the ATO. We have some big customers there. We provide the core of the wholesale payments system—the real-time gross settlement system. We earn fees from that. Where else do we earn fees, Ric?

Mr Battellino—The great bulk of the RBA's money comes from the portfolio of assets that it holds—the government securities, both domestic and foreign. The increases in profits reported there would reflect the capital gains the RBA made because market yields on securities have come down, so the value of securities rises, and also because the exchange rate came down. So all our foreign assets went up in value. That is the big thing.

Mr Macfarlane—I did not realise you were quoting our profit figures. I thought you were quoting our earnings.

Ms BURKE—Earnings after tax from the actual transactional banking business in 2000 and 2001 were $5.5 million compared with $2.1 million in the previous year.

Mr Macfarlane—I did hear you correctly.

Ms BURKE—It is your earnings.

Mr Macfarlane—Ric is talking about the big picture. I am trying to talk about the big picture.

Ms BURKE—That is why I asked about fees and charges. They are actual earnings.

Mr Macfarlane—In the little picture, we are only talking $5 million. Sums of money like that–

Ms BURKE—Do not tell the average Australian that $5 million is a small amount.

Mr Macfarlane—You can imagine how many transactions Centrelink does.

Ms BURKE—I was wondering. My understanding is that the majority of departments who have gone away from using your services are now finding that external banks are now charging them a lot more money than they did previously. Have you had any tracking of that, and is anyone coming back to the RBA for services, or have they been locked into contracts with the other banks?

Mr Macfarlane—The Auditor-General has done a report on this subject, which is quite a good report. I think he has all the information that can answer that. Basically we have lost some small customers. We have lost the department of finance; they were the first ones to go. But the big customers were reluctant to leave. So the big customers like Centrelink, ATO, Defence and Health Insurance are still with us.

Ms BURKE—You seem slightly obsessed in your annual report with trying to move employees on to individual contracts and off the certified agreement. Given that the majority of your individual contracts are actually fairly reflective of the terms and conditions of your certified agreement, why is there an obsession to move people off the EB? Do you think you have come to the end of staff reductions, as you also point out in your annual report?

Mr Macfarlane—I do not like to say that we have an obsession. I think it is true to say we have gradually moved people onto contracts. We basically did that because it gave us a lot more flexibility. We had a very archaic structure of rewards. Some of the fringe benefits were traditional banking sector fringe benefits which were totally counterproductive to us. The classic one was the subsidised mortgage. The problem was that in Sydney, where most of our people are, the young people could not afford the deposit to actually make use of the subsidised mortgage. So we were losing people. For example, in Adelaide they were living like kings. It was a structure which was totally counterproductive for our desire to acquire and to retain good people. So that is the biggest single reason why we decided that we would start with a blank sheet of paper and make sure that no-one is disadvantaged and that everyone gains from moving to a contract. No-one was forced to move to a contract. As we have moved down the levels, people are given the choice. Now I think the current exercise we are going through, about half of the people concerned—is that right?

Mr Stevens—In about the last round we made, I think about half stayed.

Mr Macfarlane—About half stayed under the old system, so no-one was forced to move. I think it has been very successful exercise. Your final question is whether we have finally reached the end point where we are no longer reducing our staff numbers. I think there is a good chance we have. This year in our budget, our staff numbers are going to go up slightly.

Mr LATHAM—Because of the space that has been opened up, with fewer staff around the place, is it true that you are becoming a landlord and that you are renting out part of the premises of Martin Place? Is this an attempt to ease the Sydney housing crisis, or are you after commercial tenants?

Mr Macfarlane—We have been a landlord for a long time, but not in Sydney. We were a landlord in the other capital cities, where we built buildings that were way bigger than our needs. For 10 or 15 years we have been a landlord in other capital cities. We still own our building in Melbourne and we have about one-half of one floor. So the rest of it is rented out. In Sydney, we have now reached the point where we cannot fully occupy the building. So we are doing a lot of work on it to make it ready to lease to private tenants. Five floors will be leased. One has already been leased.

Mr LATHAM—We will have to put some of these financial journalists in there to make it a bit easier to come to those lunches.

Mr Macfarlane—We have leased a floor to a barristers' chamber. As you know, where we are is the top end of Martin Place and Macquarie Street, which is the legal quarter of Sydney. The first floor has been leased and is occupied by some barristers.

CHAIR—Time is marching on. As you know, we got a number of emails. I thought I would move to one of them. It talks about the question of the effects on the regions. I noticed that in the October bulletin Mr Stevens made reference to the regional offices and the considerable effort that went out to get results out of the regional offices and integrate them so that you could not be accused of being Sydney-centric and all those other terrible things people say. This email says:

Is the Board supplied with separate data to assist Board members to understand and analyse rural and regional conditions before making decisions affecting Australia as a whole?

I thought you might like to expand on that.

Mr Macfarlane—I would be happy to answer that. Since it makes reference to a speech that Mr Stevens made, I think I will let him answer that.

Mr Stevens—In answer to the material that goes to the board, two things happen there, I would say. One is that the economic intelligence we get from around the country is every month worked into the regular material they get, where it can inform the judgments that are made. Secondly, periodically, they get a separate document, which gives a comparison of performance across different regions of the economy, typically by state, which is where the data are most easily available. But in some areas we have the figures also comparing metropolitan and non-metropolitan. You can do that on unemployment, for example. So they do get that information. I think I would say that we have found quite useful insights from the liaison that the regional offices have picked up.

CHAIR—I have two others. I will quickly run through them. In some ways they are representative of the wad of emails on this. One concerned the large differential between official rates and credit card rates. I thought you might want to give a two-sentence response to that.

Mr Macfarlane—I have been asked that one by this committee on a number of occasions.

CHAIR—That is why I am not expecting a long answer.

Mr Macfarlane—I usually say that I have never understood what it is. It is a good question, because it is one of the things we looked into. It is not just the difference between credit card rates and cash rates; we have looked at the difference between credit card rates and the rate charged on other forms of unsecured personal borrowing. Credit card rates are also higher than the rate on other forms of unsecured personal borrowing, which is what you should be able to compare them with.

The banks have told us that a lot of this is because of their bad debt experience. It seems to imply that there are a lot of people with credit cards who are unable to meet their commitments. I do not know whether that is true, but that is what they have claimed. I suppose the other thing I should mention is that one of the reasons why, in a sense, the public puts up with it is that when people get credit cards, they assume that they will not be borrowing on the credit card. They assume that they will pay it back in every month. In a sense, it is accidental that they end up borrowing on it. So for a lot of people, the interest rate on the credit card is not a factor that they take into account when deciding whether to get a credit card and which credit card to get. It is difficult for competition to work there because people are not interested in it.

My final comment is that, if you are actually planning to borrow on your credit card, there are credit cards available which do not have an interest-free period but which have a lower interest rate on their borrowings. Instead of paying 15 or 16 per cent, you pay 11 per cent, but you pay it from day one, the moment you make a purchase. I hope that is of some help.

Mr NAIRN—The banks have said to us in briefings recently that you can break it up into about one-third, one-third, one-third. One-third of their customers are always in debt on the credit card. One-third are never in debt on their credit card. The other third sort of accidentally fall into and out of it. Given those sorts of numbers, does that make some sense of that gap in interest rates? If everybody paid back during the interest free period, clearly they would not be making much money out of the credit card system. That is why you would expect them to operate on a high interest rate.

Mr Macfarlane—So you are saying that, since most people do not regularly borrow, you have to slug the people who do?

Mr NAIRN—That is effectively what is happening. Is it in those numbers, if it is that sort of breakup? Does it go some way to explaining the difference in interest rates?

Mr Macfarlane—The figures we had are not all that different, but they are slightly different. The figures we had were that about one-quarter of people—you say one-third—pay off their bill every month, so they never incur borrowing charges. So it is not all that different from what you were saying. I think the answer is that normally competition—say on mortgages—between banks and non-banks brought mortgage rates down. There is no doubt about that, because people were acutely aware of what the interest rate was, and they would switch from this one to that one to get a better interest rate. But with credit cards, because—in your case—two-thirds of people do not think they are going to borrow, that is not a crucial element in their decision as to which credit card to get. So the banks do not really compete with each other on their interest rates. It will not make marketing sense for them to do so, and so they do not.

CHAIR—I have one question that you might want to comment on. It comes from some backpackers in Queensland. They are talking about the differential rates for bank charges. They name them. They say that the Commonwealth Bank in Airlie Beach charges $10 per transaction to change travellers cheques cashed whereas the

Commonwealth Bank in Mackay, the nearest city to which it is located, 1½ hours drive south, charges $5 for the same service.

Mr Macfarlane—I think you ought to address that question to David Murray.

CHAIR—That was a quick hospital pass. We have a pile of these. I was wondering whether we could hand them over and get a response to them all.

Mr Macfarlane—How many do you have?

CHAIR—About 40.

Mr Macfarlane—Okay.

Mr PYNE—I have a question from left field, Mr Macfarlane. You have made comments about education policy, which some would say was outside the realms of the usual financial speeches given by the Reserve Bank governor. The government, as you would be aware, publishes the *Intergenerational Report* as part of the budget this year. One of the most crucial aspects that we have found, which is not news to anybody, of course, is the real financial issues surrounding an ageing Australia. I would be surprised if the Reserve Bank did not have a view about the burden in the future of an ageing Australia and how to address that issue. If you do have one, could you express it to us?

Mr Macfarlane—I will answer this by referring you to a speech which I made and is printed in the *Reserve Bank Bulletin* six years ago called 'The intergenerational aspect of economic policy'.

Mr PYNE—You are ahead of your time, Mr Macfarlane, yet again.

Mr GRIFFIN—Earlier, when we were talking a bit about debt, you mentioned credit card debt being about five per cent. You made the point that, if you look at the impact of that on particular sectors of society it is different. Would you care to comment on that? When we look at the level of credit card debt, we are now up over $20 billion, in the last figures. That has massively increased over the last few years. Do you have a view about how much higher that is going to go or can go? Secondly, when we look at the question of the impact on particular sectors of society, would you like to comment on just who in particular is getting hurt?

Mr Macfarlane—I am going to have to disappoint you a little bit. Your question is a good one. I think there are groups who could give you a very good answer to that who have done research on that, but we are not one of them. Our mandate in looking at the credit card issue was to look at competition and efficiency. We are not there in terms of consumer protection or anything like that. We go out of our way to keep narrowly to our mandate. We are interested in the credit card as a transaction device, as part of the payments system. We are really interested in the payments aspect of the credit card. We are not interested in the credit bit that is tacked onto it, even though the two things are obviously clearly put together. We are really interested in the credit card insofar as it is a transactions mechanism. The reason we got into this is that it is the most expensive transactions mechanism and yet it was the mechanism which was growing fastest. That is how we got into it—on the efficiency and competition angle.

Mr GRIFFIN—I accept that. In the context of the talk about household debt, although it is only five per cent, it has been growing astronomically. It is certainly my view—and I have seen some stuff on it—that for the under-30s it is a bigger issue in terms of disposable income. There are some figures that have come through which would suggest that it is a greater problem for people in that range.

Mr Macfarlane—It may well be, and it sort of makes sense. But there are other bodies that look into that and have collected figures on that. They would be able to speak much more authoritatively on it than I could.

Mr NAIRN—You mentioned the ACCC. Apparently the ACCC is looking at BPay and aspects of that. Has there been any liaison between the RBA and the ACCC with respect to BPay?

Mr Macfarlane—No.

Mr NAIRN—Would you expect there to be, because it is a payment system?

Mr Macfarlane—It is a good question. It is part of the payments system; you are absolutely right. It involves an interchange fee. The reason the ACCC is looking into it is that there was a complaint made to the ACCC by someone, a user, a business or a merchant. They have to follow up any complaint that is made to them. They are in that phase, I presume, at the moment. But I have not spoken to them about it.

CHAIR—I think we have had a pretty good run. If are you going to stray into public policy again, you might look at the function of the Senate. You will not want to comment on that today.

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

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.

Again, I thank everyone very much for coming here today, particularly the governor, Mr Battellino, Mr Stephens and Dr Edey, and everyone else who has come along today. It has been a very worthwhile hearing. As always, I hope that it plays a positive role in the better understanding of the work that the Reserve Bank does, its functions and its influence on the economy of Australia. Thank you. Thanks to Hansard.

Committee adjourned at 1.35 p.m.