COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2002-03

MONDAY, 8 DECEMBER 2003

BRISBANE

BY AUTHORITY OF THE HOUSE OF REPRESENTATIVES

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Monday, 8 December 2003

Members: Mr Hawker *(Chair)*, Ms Burke *(Deputy Chair)*, Mr Albanese, Mr Cox, Ms Gambaro, Mr Griffin, Mr Peter King, Mr Nairn, Mr Somlyay and Dr Southcott

Members in attendance: Ms Burke, Mr Cox, Ms Gambaro, Mr Hawker, Mr Nairn, Mr Somlyay and Dr Southcott

Terms of reference for the inquiry:

Reserve Bank of Australia annual report 2002-03

WITNESSES

Committee met at 9.59 a.m.

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

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

MACFARLANE, Mr Ian, Governor, Reserve Bank of Australia

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

VEALE, Dr John Michael, Acting Assistant Governor (Financial System), Reserve Bank of Australia

CHAIR—I declare open this hearing and welcome representatives of the Reserve Bank, students and staff from universities and secondary schools in the Brisbane area, members of the public and members of the media. This is the first time we have ever had a hearing in Brisbane and it is very much thanks to our Queensland colleagues, Alex Somlyay and Teresa Gambaro, who have been quietly but quite firmly lobbying the committee.

The hearing today comes at a very interesting time in Australia's monetary policy. It follows two Reserve Bank decisions to increase interest rates, from 4.75 per cent to five per cent in November and from five per cent to 5.25 per cent last week. These were the first increases in interest rates in 17 months, and the governor of the bank today will have the opportunity to elaborate on the reasons for these increases and the likely effects they are going to have on the economy over the coming year or so. Other issues we will discuss today with the governor include the rise in the value of the Australian dollar, the level of housing related credit, the impact of the world economy on Australia and progress on reforms to Australia's payment systems, particularly with regard to fees.

Once again, on behalf of the committee I welcome the governor and other senior officials from the Reserve Bank of Australia to this hearing. I would also like on behalf of the committee to congratulate the governor on his reappointment for a further three years. I remind the witnesses 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 parliament. Mr Macfarlane, would you like to proceed with your opening statement before we proceed to questions?

Mr Macfarlane—Thank you very much, I will. I should start by saying it is a pleasure to be in front of your committee again and a special pleasure to be able to meet in Brisbane for the first time. As you know, we take these hearings very seriously because they enable parliament through its representatives on the committee to question the Reserve Bank in depth and in public. As usual, I will cover a few subjects in my introductory remarks. In fact, I will focus on three: firstly, I will cover how the situation has changed since the statement I gave to this committee in June; secondly, I will cover, as usual, how our forecasts have evolved; and, thirdly, I will give some more detail on the background to our monetary policy actions.

I will start with the first of those subjects, which is how the situation has changed since I spoke to the committee in June. Calendar year 2003 was a very unusual one for the world economy. In the first half, prospects for the world economy looked doubtful, with the most extreme uncertainty being concentrated in midyear. If you remember, this was when talk of possible deflation in the United States reached its peak and the US authorities gave the impression that they needed both lower interest rates and a lower US dollar to help them through. In Europe at the same time economic activity was weakening, and in Asia they received a temporary knock-back from the SARS outbreak. At that time, virtually all the central banks of note—the Fed, the ECB, the Bank of England, the Bank of Canada et cetera—reduced interest rates, and I indicated to this committee that if things did not improve we might have to do the same.

In the event, we did not, because we witnessed one of the sharpest turnarounds in economic prospects any of us have seen. While in the June quarter most major countries, including many in Asia, saw declines in GDP, by the September quarter every one was growing strongly. The weakness we saw in the June quarter turned out to be a 'false signal'. In financial markets, bond yields rose sharply, share prices continued to rise and various prices connected with international trade, such as commodity prices and bulk transport prices, also rose. Talk of deflation ceased and the short-lived bout of monetary policy easings stopped. Business and consumer confidence around the world rose back to levels which were consistent with reasonable economic growth.

At the same time as perceptions of the world economy were being raised, the general run of economic indicators in Australia continued to improve, particularly employment, retail sales, construction activity and business and consumer confidence. Prospects for farm production also picked up sharply following widespread rain. Economic conditions here and abroad had returned to something relatively normal and, as a consequence, we judged that we no longer needed such an expansionary setting of monetary policy, so interest rates were raised accordingly in November and December.

I turn now to the forecasts. I will start by discussing the forecasts that I gave at the previous meeting and comparing them with how we think things are now going to turn out. When we last met in June, I said we expected GDP to grow by three per cent in real terms over the course of this year—that is, calendar year 2003. Now, with three-quarters of the year behind us, we expect that figure will come in a little higher, at about 3½ per cent. The thing to notice in particular is the big difference between the two halves of the year, which fits in with what I was saying earlier. Growth in the first half of the year was at an annual rate of about two per cent, while growth in the second half is expected to be at an annual rate of around five per cent. The other thing to notice is that the growth of domestic spending, or gross national expenditure, through this year, at five per cent, is again expected to be well above the figure for GDP, at 3½ per cent. That, again, is an indication that the domestic economy is a lot stronger than the world economy.

Looking ahead, over the course of 2004 we expect GDP to grow by four per cent. The profile of growth, however, is unlikely to be smooth. It would not surprise us if the four-quarter-ended growth rate of GDP reached 4½ per cent in mid-2004, due to the sharp rise in farm GDP, before returning to four per cent by end year. If the world economy continues to surprise on the strong side, as it has in recent months, our GDP growth could be even higher.

On inflation, we said last time that we expected the CPI to increase by 2½ per cent over calendar 2003. We now think it will be a little lower, at 2¼ per cent, largely due to the exchange rate being higher than assumed at the time we made our earlier forecast. Looking ahead, over the course of 2004 we expect the CPI to increase by two per cent, but in mid-2004 it could well be below that because the maximum effects of the higher Australian dollar could be being felt by then. As we stated in our quarterly statement, this expectation implies that the profile for inflation will exhibit a shallow U shape—falling from its present 2½ per cent to below two per cent in mid-2004, then rising back to two per cent by end 2004, 2½ per cent by mid-2005 and, in our view, being under upward pressure thereafter. Of course, it is very difficult to be precise about these things, especially since future levels of the exchange rate will play a major role. I will say a bit more about this later.

I now turn to monetary policy. As I outlined at the start of these remarks, with growth in the world economy getting back to normal, and growth in the Australian economy also getting back to normal, or slightly above it, we could no longer see a justification for Australian interest rates being clearly below normal. That is, the major reason for the two increases in interest rates this quarter is the same as I gave to the committee 18 months ago, in late May 2002, when talking about the tightening at that time. Another way of putting this is to say that if we had maintained the low level of interest rates we had at the beginning of 2002 there would have been a gradual build-up in inflationary pressures as the growth rates of the world and Australian economies rose through 2003, 2004 and beyond. Interest rates were just too low for an economy that was growing that well. As it turned out, this process of returning interest rates to more normal levels has been a gradual one. Two increases in interest rates were made in mid-2002, then there was a 16-month gap to the next two increases. I have explained in previous meetings the reason why this long gap occurred.

It is clear that, despite our best endeavours to explain ourselves, a number of people think that the bank tightened monetary policy to cool down the property market. In fact, I have more than once received unsolicited advice that it would be better for us to explain our action in this way because people could more easily identify with it. The overheated property market is something that people can see around them; it is much more concrete than such concepts as inflation targeting or returning interest rates to normal.

However, such an approach would not be consistent with the truth. For a start, signs of overheating in the housing market were clearly evident through the second half of 2002 and all through 2003, yet the bank did not change monetary policy. It was only when it became clear that good economic growth had returned both globally and domestically that rates were raised. I have often stressed that monetary policy has to be set taking into account the average of all the parts of the economy, not just what is happening in one sector. Of course, if a sector is overheated it may push up the average for the economy and in that way exert a disproportionate influence. It is also true that, historically, borrowing for housing purposes has been one of the more interest-sensitive sectors, and so it may have been more affected than other sectors by the previous low level of interest rates and it may respond more than other sectors to the recent increases. But that does not mean we singled it out.

We have also been accused of setting monetary policy in relation to the Sydney and Melbourne housing markets and ignoring the rest of the country. This clearly cannot be true in the case of the recent tightenings, as house prices in Sydney and Melbourne are growing less quickly than in all other states. In fact, in some sectors housing prices in Sydney and Melbourne are probably already falling.

In Australia we have conducted monetary policy by using an inflation targeting regime for about a decade now. It has been a very successful regime in that it has delivered, along with various other reforms, the longest period of uninterrupted good economic growth in the post-war period at a rate exceeding that of all other significant developed countries. It has concentrated our minds at the Reserve Bank in that we have been very conscious of our need to deliver the results to which we have committed. Over the 10-year period, inflation has averaged 2.4 per cent. By acting early on monetary policy to keep inflation in check we have avoided large swings in interest rates and thereby allowed the economy to prosper.

As you are aware, our target is a relatively flexible one in that we aim to achieve an average of two to three per cent—that is, we look to inflation averaging two point something per cent. It is that average by which we should be judged or made accountable. But there are some observers who think that the system should be more prescriptive than this and that there should be some strict rule which would determine our actions. For example, a few people—although not many, I must confess—still think we should aim to keep inflation between two and three per cent at all times. This is a clear misinterpretation of our system because it fails to realise that it is the average we are interested in. On a number of occasions, inflation has been above three per cent and below two per cent. In fact, in 45 per cent of that 10-year period it has been outside the two to three per cent range, and we have not regarded this as a failure of policy.

Since our objective is to achieve an average inflation rate, there are multiple paths for inflation which are consistent with meeting our medium-term objective. We wish to choose the one which best satisfies the other obligations contained in our act. There are three of them, which I summarise as: achieving sustainable growth in income and employment. We are not simplistically committed to achieving the minimum possible variability in inflation, or even hitting the target at some fixed period ahead, such as two years.

Another approach sometimes put to us is to say that we should raise interest rates if, and only if, our forecast for inflation is above three per cent, and lower interest rates if, and only if, it is below two per cent. Again, this is a misinterpretation of how the system works. It also ignores the complications and uncertainties involved in economic forecasting. The forecasting horizon relevant for such a policy is at least two, or even three, years. We can be relatively confident about forecasts for the first half of that horizon as much of what is going to happen has already been set in place, but we can be much less confident about the forecasts for the second half. The situation is particularly uncertain when, as is the case at present, the direction of inflation is expected to change during the forecast period.

Since this type of forecast is so hard to make, we, like a number of other central banks, do not wish to lead the public to believe that we can do this with much precision. In fact, we tend to appeal to the balance of risks around the central forecast in order to convey our message. In last month's quarterly statement we said that the balance of risks was shifting to the upside, which was meant to indicate that inflation was on an upward trajectory through the course of the second half of the two- to three-year period. We also drew attention to the fact that domestic price pressures were increasing, as shown by the fact that the rate of increase in the prices of 'non-internationally traded goods and services' had increased from two per cent to four per cent over the past two years. That does not mean that inflation will rise to four per cent once the exchange rate effects wear off, but at least a significant part of the economy will be influenced by this figure.

In summary, I want to assure the committee that the bank remains committed to the inflation targeting framework and that decisions taken over the past 18 months have been fully consistent with that approach. It does not seem plausible to us to argue that the bank could have been confident of meeting its inflation commitments if interest rates had been held at 30-year lows in the face of the pick-up in the international and domestic economies that is current under way.

Finally, let me end by updating you on a few developments in the payments policy reforms. Since we last met, the challenges brought against the Reserve Bank’s reforms to credit card schemes by MasterCard and Visa were dismissed by the Federal Court. Both schemes subsequently appealed, but Visa has withdrawn its appeal. The new interchange fees for Bankcard, MasterCard and Visa came into effect at the end of October, almost halving the interchange fees. The Reserve Bank is monitoring the flow-through of this to merchant service fees. The data are still being gathered, but anecdotal evidence suggests that merchants are starting to see a reduction in the merchant service fee they pay to banks. There have been several developments in other payments’ streams and I will be happy to answer questions on those when they arise—as I will be happy to answer questions on any subjects when they arise—but I am aware that I have already taken a fair amount of your time so I will finish at this point. Thank you very much.

CHAIR—Thank you very much, Mr Macfarlane, for that very detailed defence of current policies. Before we move on, I would like a motion that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication.

Mr COX—I so move.

Ms GAMBARO—I second the motion.

CHAIR—There being no objection, it is so ordered. Mr Macfarlane, in your comments about inflation you talked about the fact that you could see it coming down further—mainly as an exchange rate result, I think—to two per cent over the course of 2004. As I recall, your reference 12 or 18 months ago when you were talking about moving interest rates was that a more normal level would be something like inflation plus about three per cent. Would it be reasonable to say therefore that this second rate rise should be sufficient, despite what other commentators are saying, to leave interest rates there for some considerable time into the course of the next year?

Mr Macfarlane—I think you are bringing up this subject of getting interest rates back to neutral or normal. We have always found that to be a very useful way of thinking about monetary policy determination for several reasons. The main reason is that it forces you to think in terms of a medium-term focus, and the other is that it forces you to think in terms of the level of interest rates rather than just the changes. During questioning from this committee you said, ‘Well, this is all very well and very interesting, but what is the actual numerical rate?’ In fact, that is the first time—I think the only time—we have spoken in public about an actual numerical rate. I think that tells you something. It says that if we thought it was possible to calculate this numerical rate with great precision and that it would be a fantastic guiding star, we would have already produced papers on it and put out a whole lot of stuff on that matter; whereas the only reason it is in the public arena is that this committee said, ‘You’re talking about normal or neutral; tell us what it is.’ So in some sense you could say it was almost dragged out of us reluctantly.

CHAIR—We could still ask you.

Mr Macfarlane—I think it was correct of you to ask for it because if we talk about it we cannot dodge the subject of saying what its level is roughly, and that is right. We said that if inflation expectations are 2½ per cent, the normal real interest rate is roughly three to 3½ per cent, so it is somewhere between 5½ and six per cent.

The other thing I want to say about the concept of a normal interest rate is that it is a wonderful thing to have when you are a long way away from it. It keeps reminding you: do you really want to be this far away—whether you are above or below? Do you think you really need to be exerting this much stimulus? Or, if you are above the thing, do you really need to be exerting this much contraction? So when you are a fair way away from it, it is a very good discipline that asks you whether you need to be there. The thing is that once you get quite close to it, it is no longer anywhere near as big a discipline, for several reasons. One of the reasons is that you are not absolutely confident in those figures—that 5½ to six per cent. It might be 5¼ to 6¼—who knows. You certainly know that, if you are a long way away from it, you should be getting back to it, but when you are very close to it, it is not necessarily all that clear.

It is interesting that you asked the question in the way you did, Mr Chairman. My interpretation of your question was that you were saying, ‘You’re already there, aren’t you?’ There is a lot of other speculation in the press which says the exact opposite. It says: ‘You’re at 5¼ per cent. Now you still have a quarter or a half to go to get to the midpoint.’ So there is quite a lot of speculation about that. As I said, I would like to hose down a fair bit of that speculation. Firstly, the numbers are fuzzy and we cannot be 100 per cent confident in them. Secondly, when you are one or two percentage points away from them, you certainly know you are a fair way away from them; when you are a quarter of a per cent, maybe it does not tell you all that much. Thirdly—this is most important—it is just a general guide; it is not something you have to get back to come what may.

In fact, the first time we gave you that particular piece of guidance was in May 2002. If it was something we had to get back to, we certainly did not do our job. We basically sat there and did one little move, then we did nothing for 16 months. Other things can come along and get in the way. And we know what big things came along on that occasion and got in the way: the world economy weakened significantly and, domestically, the economy started to weaken too, in large part because the drought turned out to be more severe than we thought. So even though it is a general indication, it is a very fuzzy indication.

CHAIR—Maybe I could come at this from another perspective. As you have said again today, the US economy and other world economies are picking up. But we have not seen the Fed and others choose to increase their interest rates, yet we have increased twice. And the OECD in their economic outlook published last month made the observation that Australia’s short-term interest rates are forecast to be five per cent throughout the whole of 2004, yet we are already above that. I wonder if you can comment on those two points.

Mr Macfarlane—Once again, if you want to talk about the OECD, all the newspapers I read said that the OECD said Australian interest rates should go up by one per cent, which is what they said. Then if you turn to a particular table it actually shows that in the assumptions in their table they did not have that happening in 2004, they had it all happening in 2005. I do not know that I can say much more about the OECD than that, other than that the main interpretation in the press was that they were telling us, as the IMF have been telling us, that interest rates should be higher. So let’s leave that aside and address the other issue, which is: why is it that other countries have low interest rates?

CHAIR—And have not chosen to move yet.

Mr Macfarlane—And, by and large, have not chosen to move. The answer to that is, basically, our economy is in much better shape than any of those other economies. All those economies are still suffering from the aftermath of the bursting of an asset price bubble and, in most cases, the fact that they had a recession. As a result they are in the early stages of a recovery from a recession and they are not fully confident that that recovery is occurring, although in some cases they should be much more confident by now. That explains most of the countries that you would compare us to. There are a couple of others that actually did not have a recession. The UK did not have a recession, nor did Canada. They both had a big bursting of an asset price bubble, but they got through the period without a recession. The UK has started to raise interest rates; Canada has not. But, again, if you look at the figures for Australia and compare them with those countries, Australia over the last three years has grown significantly faster in real terms and significantly faster in nominal terms because our inflation rate is a bit higher. We are in this happy position of having a healthier economy that is growing better and in fact has been growing better than our comparative countries around the world for the last decade. I think we should in some sense rejoice in that rather than look on the gloomy side of things and say, ‘Oh, but our interest rates are higher.’ The two things go together, and I know which one I would prefer to have—a good healthy economy with normal interest rates, rather than a sick economy with low interest rates.

CHAIR—With interest rates going up sooner here than for others—apart from the UK, as you said—one of the things that that exacerbates is the rise in the Australian dollar. I think it is gone up some 45 per cent in the last two years against the US dollar, and the trade weighted index is the highest it has been since 1989. I am just wondering how much you factor that in. In your statement when you raised interest rates and again today you talked about what it might do to inflation. But when do you reach the point of being concerned that it is going to seriously affect the export sector of the economy?

Mr Macfarlane—We certainly do take it into account. It gets into all our forecasts. It gets into our assessments. We know that it is obviously much easier for businesses with a low exchange rate—they have a bit of a tailwind behind them; and when they have a high exchange rate they have a bit of a headwind. We know that a rising exchange rate exerts a contractionary effect on economic activity and it reduces inflation below what it would otherwise be. So it gets into our general assessment of monetary policy. It is in there along with all the other variables: what is happening to GDP, what is happening to employment, what is happening to growth in the rest of the world. It is not an objective on its own; it is in there with all the other variables that we take into account.

Since you mention it, I think we must recognise—and I think most people do—that the Australian dollar did not rise because interest rates went up by 50 or 100 basis points. Basically, the main part of the rise you referred to—some 45 per cent—is explained by two factors. The first is that the starting point was ridiculously low. When historians look back and see the behaviour of the Australian dollar, to see where it has really departed from its logical behaviour, what they will look at is the 47c that occurred in 2001. They will say: 'How in the hell did that happen?' That is such an outlier. Obviously any increase which has occurred since then—once again, I hate to get back to this—has a lot to do with returning to normal.

The second biggest influence which has been occurring lately is the fall in the US dollar over the last year. That explains the bulk of it. Let me look at it another way. The US dollar has fallen against the major floating currencies, which would be the euro, the pound, the Swiss franc, the Australian dollar and the Canadian dollar. The US dollar has fallen by 23 per cent against those and it has fallen by 29 per cent against the Australian dollar—or ours has risen by 29 per cent against the US dollar. In other words, 23 of the 29 is basically the US dollar falling against everyone. I think people recognise that. So the two biggest influences on the rise in the Australian dollar, as it is perceived—it is the Australian dollar and the US dollar that people look at—are, firstly, the return from a very low figure; and, secondly, the fall in the US dollar.

The Australian dollar has obviously shown a fair bit of strength in the last three months. The very recent lift in the Australian dollar continues to be influenced by those two factors, but is also influenced by the fact that the world economy is growing, the Australian economy is growing and commodity prices are rising. In fact, of the commodity prices we put in the commodity price index that we construct—there are about 20 commodities—they are all rising except one, which is wool. This is exactly the period when one would expect the Australian dollar to rise.

I have not mentioned another effect, which is interest rates. Obviously interest rates play a role. An interest rates differential is often an important influence on where an exchange rate moves to. At the moment, it is not playing a huge role because these other things are driving it. One of the ways I would illustrate that is that the Australian dollar has not risen very much at all—in fact it has fallen against some currencies that have not been putting their interest rates up. For example, the New Zealanders have not put their interest rates up; they have put them down three times this year. And yet the New Zealand dollar has risen more than the Australian dollar. In fact, the New Zealand dollar has risen more than the Australian dollar even over the last month, when we have had two increases in interest rates.

I do not want to use that to say that interest rates do not matter, because they normally do. They are normally quite important. They are a bit difficult to quantify over any particular period but quite important. At the moment I think the big dynamic on the Australian dollar is being driven by the weakening US dollar, the strengthening world economy and rising commodity prices. They are doing most of the work. Even if we were to change our view of the world and say that we are no longer going to conduct monetary policy for the whole economy but we are going to try and direct it at what is happening to the exchange rate—that is, by not raising interest rates—I would doubt whether it would have much effect, just as in New Zealand the fact that they did not put up their interest rates had no effect.

Ms BURKE—Do you think Australia is returning to a commodity economy? In our hearings going back several years we have talked about this. We were proud of ourselves for moving away from being a commodity economy, but we seem to be going back there.

Mr Macfarlane—I do not think we are. I think that the share of commodities in our exports is still going down—not very rapidly. These things do not change very rapidly. It took 20 years for them to get down from 70 per cent to 60 per cent. I do not know what the latest figures are. They are probably edging down. I think what is happening or what you are referring to is that, at this particular moment in the world, the countries that are seen to be doing well are countries that have quite a high exposure to commodities, such as Australia, New Zealand or Canada. If you want to find the country with the fastest rising exchange rate, it is South Africa. The South African rand is going up faster than anyone’s currency. We are not becoming more commodity intensive but we are deriving a benefit from the fact that, by world standards, the existing level of our exposure to commodities is very high.

Ms BURKE—The question I wanted to lead off with is the most predictable, I suppose. Given that the committee has not been very successful in getting greater transparency out of the board deliberations, were the two recent rate rises unanimous decisions taken by the board?

Mr Macfarlane—I am sorry, I am not prepared to answer that one. The basis of our system is that we do not disclose voting patterns. It is true that at the last meeting there was regrettably a press release on the morning of the meeting which contained a statement about how a particular party had voted. You asked me if it was true and I said: ‘I cannot tell a lie. Yes, it is true.’ But on occasions where we have not had a breach of confidence like that, I would still much prefer to stick with our present practice of not disclosing voting records. If you want, I can explain in greater detail one of the reasons why I feel quite strongly about that. Whereas in some countries where they have a different structure of their central bank board it does make sense for them to do that, but I do not believe it makes sense in Australia to do that.

Ms BURKE—It is interesting then that in your November statement you quite clearly outlined on page 11 that you know what is happening in the UK because the board minutes predict that there was a vote against. Your previous answer is that, by virtue of the differences in the boards, there is no need for us to know what goes on behind those closed doors.

Mr Macfarlane—The board of the monetary policy committee of the Bank of England consists of five Bank of England officials and four outsiders who are essentially academic economists and who are pretty well full-time employed as board members of the Bank of England. They do not represent the broader community. They are basically all academic monetary economists. We have a very different type of board. We have a board which is designed to represent the broader community. We have people who come from a retailing background, farming background or mining background. It would be impossible for them to do their job if their vote were disclosed.

In fact, we saw something very close to that recently whereby a particular senator was attacking the decision on the ground that it was harmful to rural interests. While being interviewed he was saying there should be more farmers on the board. Then someone said: ‘You have got one; you’ve got Donald McGauchie. What did Donald McGauchie say? What did he think?’ His position would become impossible if we had to disclose his vote. When these people come to the Reserve Bank board, they have to forget their sectional interests. They have to come along and say, ‘I am making a decision for the whole economy; I am not making a decision for the sector that I come from.’ To get them to do that, you have to provide them with the fact that their statements and their votes are confidential, otherwise they will be put under public pressure to revert to being simply sectional advocates.

Ms BURKE—In conclusion, was there disagreement—if I can put it that way, and do not go on the vote—about your forecast and the basis on which you made the two recent rate rises? With the economic fundamentals you were putting forward, which are at odds with the Treasury’s, was there disagreement around the fundamentals and the forecasting for the basis of moving the two rate rises?

Mr Macfarlane—No. There was no such disagreement.

Dr SOUTHCOTT—Mr Macfarlane, I would like to ask you about the timing of the last two interest rate rises. Given that your inflation forecast for 12 months time is for two per cent, why did the bank decide to commence the rises in November and December?

Mr Macfarlane—The first thing is that I hope I made it clear in my introductory comments that we do not try to finetune inflation. If we thought that inflation was going to be at a particular place in the next 12 months, for example, largely because of what has happened to the exchange rate, we would not try to offset that with a movement in interest rates. For example, the only way you could do it here would be to push interest rates down by a huge margin. If you did that, when the exchange rate effects had worn off you would be left with an inflation rate which was much higher. So then you would have to put interest rates up by a huge margin. You would end up with interest rates going all over the place if you tried to finetune inflation in that way. There is a name for it in the economic literature: instrument instability. That is why the only way you can make an inflation targeting regime work is to have in mind what you think the inflation rate will be somewhere between two and three years out.

That, as it turns out, is also a weakness of inflation targeting, because no-one can really forecast out there with precision. If you put down a particular number—X.X—it would be very difficult to defend that against someone who had some different assumptions. So, in our view, you have got to make the mental effort to think, ‘What is going to happen out there?’ and communicate that without necessarily committing yourself to a hard number. Mind you, this is true of all other central banks too. We have done a study of this. Basically, they cannot forecast out beyond two years. Those who do actually put a number always put a number that is in the middle of their range. What we try to do is get the impression of where we think the forces are coming from. In our view, had we persevered with that lower level of interest rates then, in time, forces would have built up which would have meant that, in that two- to three-year horizon, in all probability inflation would be on an upward trajectory—and not just a temporary one but one that you would have to do something about. So that is why we did it early.

This is another of the virtues, by the way, of this concept of thinking in terms of normal level. It encourages you to move early. The other alternative is the way which, I think, monetary policy used to be conducted when it was more politicised. There was a huge reluctance to put interest rates up; and you could only really get political consensus to do it if something was already clearly going wrong. So it is true that interest rates did go up, but they always went up too late.

We believe that, in the system we have, they go up early; and, because they go up early, they do not have to go up as far.

Dr SOUTHCOTT—In your November statement on monetary policy, you mention one of the upside risks being a risk that the exchange rate rises are not passed through to decreases in retail prices in that businesses will be rebuilding their margins. Given that we have consumers much more informed than ever before—they are able to check prices on the Internet, for example—more competition than before, and the media currently suggesting to people that they should expect further decreases in prices in imported consumer items over the next three to six months, does the bank see this as a likely upside risk to inflation?

Mr Macfarlane—I would not call it an upside risk.

Dr SOUTHCOTT—On the upside—

Mr Macfarlane—Obviously, with a higher exchange rate, other things being equal, that is going to push down inflation. I think we were saying that maybe it is not going to push it down quite as much as it would have on the basis of past relationships. So it is still going to push it down but maybe not quite as much. We have done some empirical work on this both in terms of falling exchange rates and rising exchange rates and we have discovered that in both directions the pass through is not as big as it used to be. So it is not just that when the exchange rate is rising they will not pass things through in terms of lower product prices. When the exchange rate fell, a lot of that was not passed through either; a lot of that was absorbed by the importers in lower profits.

There was a classic example, if you can remember, back in that period from about the beginning of 2000 until the middle of 2001 when the exchange rate fell by an enormous amount and the price of imported cars in Australia hardly went up at all. Either the manufacturer or the importer absorbed it in their margins. They basically priced to what the market would bear. And so when the exchange rate went back up again one of the main things they did was restore their profits. That is the sort of pattern that we think we are seeing, and that is meaning that the changes in the exchange rate do not have as big an impact on domestic inflation as they used to have.

CHAIR—I suppose you hope the banks do not follow that trend.

Dr SOUTHCOTT—Mr Macfarlane, do the forecasts you have factor in the December increase in interest rates as well?

Mr Macfarlane—The forecast I gave you this morning?

Dr SOUTHCOTT—Yes. Does that factor into the December increase in interest rates?

Mr Macfarlane—Yes, it would, however imperfectly. It is actually very difficult to distinguish between a no policy change forecast and a policy change forecast, but that forecast was actually made after the receipt of the September quarter national accounts, which as you might know was the day after our board meeting.

Mr COX—You have put most of the emphasis on inflation in your comments this morning and you have said that in setting policy you virtually disregard the downward effect on inflation and exchange rate appreciation. Is your view symmetrical, in that when the exchange rate eventually starts to fall again you would disregard the inflationary effects of that?

Mr Macfarlane—The answer is yes. I explained some of that in my answer to Dr Southcott’s question. We do spend a lot of time looking at this issue of how changes in the exchange rate flow through to inflation. We are finding that it is symmetrical, that the falls in the exchange rate were not as inflationary as they would have been 10 or 20 years ago and the rises in the exchange rate are not as disinflationary as they would have been. I would maintain very definitely that our attitude to this is symmetrical.

Mr COX—What is your outlook for exchange rates? We have seen an improvement in our terms of trade in the last few years, whereas before they had been in very long-term decline. Do you see the fundamentals as taking the exchange rate to some normal level that is increasing?

Mr Macfarlane—I think there are two ways of answering this, because there are two time frames that we can consider it over. One is very long run and the other is cyclical. I have said on many occasions that I think that the long run trend decline in the Australian terms of trade, which occurred for about 80 or 100 years, stopped in about the mid-eighties. Since then there has been a tendency for the Australian terms of trade to rise. I have given reasons for that. It is all to do with where excess capacity occurs in the world. It always used to occur in resource industries, whereas now I believe it occurs in manufacturing industries. I do not know whether that was the one you were referring to, but there is evidence that this is one of the things that has helped us have such a good economic performance over the last decade or so.

The main thing that has happened is that the falling trend has stopped, and that is good news. The extent to which the trend has now turned up is difficult to discern. It probably has turned up, but only very gradually. But, around the trend, there are still cyclical movements. If you look at a graph of the Australian terms of trade, you will see there are still quite significant cyclical movements around that trend. I think what is happening at the moment with the sharp lift in commodity prices is a cyclical event, and it is particularly associated with the almost insatiable demand for commodities from China. You have probably read some of these stories about what is happening to coal, iron ore, aluminium and nickel prices. The other indicator of this is what is happening to shipping prices—they do not have enough ships to supply China with what it demands. There is an obscure index called the Baltic Dry Index, which is the price of hiring bulk carriers. That price has just gone through the roof. What we are seeing at the moment is a cyclical event, and cyclical events do not last all that long. At the moment, the pressure you are seeing on the Australian dollar is coming from that cyclical event, not because people are taking a 100-year view of history.

Mr NAIRN—Mr Macfarlane, earlier on you said you would rather have a healthy economy with higher interest rates than a sick economy with low interest rates. I would argue that over the last couple of years we have actually had a healthy economy with low interest rates and that that consistency, in my view, has assisted business to build confidence. How much would you factor in that aspect? Certainly in the 20 years that I was involved in the small business part of politics, I cannot recall any time where there was such a long period of consistent low interest rates. I do not recall that there was ever even a period of consistent interest rates. That certainly has a huge psychological effect on businesses: they plan five or 10 years ahead. My question is: how much is that sort of psychological effect on business taken into account in when and how often you raise interest rates? It seemed to me that, as soon as you raised interest rates by a quarter of a per cent in November, everybody virtually knew it was going to go another quarter in December—why not half in November? I will pull those two questions together.

Mr Macfarlane—In answering, I think you misquoted me slightly, but *Hansard* will be able to determine whether that was the case. My memory is that I said I would prefer to have a strong economy with normal interest rates rather than a weak economy with low interest rates. I am not arguing for high interest rates; I was arguing that they are only held below normal if an economy is weak. So, I hope I am right on that—we will find out at some stage. That is certainly what I meant to say.

On the second issue, you are absolutely right. The last 10 or 12 years has been a period of low interest rates in Australia, by historical standards—or certainly by the standards of the decades of the seventies and eighties. The last 10 or 12 years has been a period of both low and relatively stable interest rates. There is one overwhelming reason for that, and that is that there has been a period of low and stable inflation. Once you achieve that point of low and stable inflation, you can then have interest rates which are much lower than they were in periods where you did not have low and stable inflation. I have absolutely no doubt that that has greatly contributed to the ease of doing business in Australia. It is at the heart of our whole monetary policy framework.

Ms GAMBARO—Mr Macfarlane, I want to follow on from Anna Burke’s question about the composition of the board and recent criticisms by a senator that the higher dollar does not reflect what is happening in the rural sector when it is recovering from drought. I notice that you have opened up more of these regional offices to give you feedback. In light of what is happening in the housing sector, particularly with Sydney and Melbourne prices, which you spoke about at the last hearing—we have also had huge increases in Brisbane—can you tell me about how the contacts with these regional offices work and the sort of feedback that you are getting across industry levels that helps you make decisions about interest rate rises?

Mr Macfarlane—We have a regional office here in Brisbane. Peter Gallagher is the head of it; he is sitting behind me. We have a regional office in Melbourne, which also looks after Tasmania. We have a regional office in Perth and we have a regional office in Adelaide. These people do nothing but economic liaison—meeting businesses and industries and local government. In the old days, when we had branches in these cities, we did not do anywhere near as much of that, because our branches were actually doing banking. Now that we have these regional offices, they specialise in that sort of economic liaison.

The big difference between then and now is that these people are actually members of our economic department. They report directly to Malcolm Edey, who is sitting on my right, and they regularly return to Sydney to have meetings—they are not just stuck away in an outpost. They meet each other and they meet with our economic group, and the information that they obtain on a regular basis is fed into the forecasts and the assessments that the economic department make. As well as that, from time to time we can just give them assignments. We want to know more about what is going on in such and such an area so we ask them and they go out and do that. Our contact with not just the business community but the farming community and the resource community, retailers and builders outside Sydney and Melbourne is much greater than it has ever been.

Ms GAMBARO—Auction clearance rates have slowed in Sydney recently. Do you see this as a correcting of the marketplace? Do you have any concerns about that?

Mr Macfarlane—That is a very light lead-in to a very big question. Before I answer it, I would like to know whether the chair is happy for the discussion to move in that direction.

CHAIR—We might finish monetary policy and come back to that question.

Ms GAMBARO—Going back to monetary policy, what sort of an effect do you see the tightening of interest rates having on GDP growth? Before, in past cycles, there have been effects on GDP growth in terms of the downturn. I can leave those questions if you prefer, as we will be going to the housing sector.

Mr Macfarlane—At the margin, obviously, any rise in interest rates means that, once these things have worked their way through, GDP growth will be slightly lower than it would otherwise have been in the short run—over an 18-month period or something. Over a slightly longer run, inflation will be very slightly lower than it would otherwise have been. But we have not got a little arithmetic formula whereby we can say, ‘A quarter of a per cent on the cash rate means 0.1 per cent on GDP.’ I have no doubt we could construct models that would show that, but we would not have a lot of confidence in them because there would be quite a lot of variation from model to model. But at the margin it does mean that it would grow less rapidly than it would otherwise grow. But, I said in those forecasts, we think that is going to be growing very nicely, thank you, even with those. We are looking at four per cent growth in the next calendar year.

Ms GAMBARO—Thank you very much.

CHAIR—Mr Macfarlane, in terms of the forecast estimates, the unemployment rate is now at 5.6 per cent—which is back to where it was in 1989; at what stage do you factor in the unemployment rate, particularly in terms of NAIRU, the non-accelerating inflation rate of unemployment? At what point does that cut in?

Mr Macfarlane—I have been asked a couple of times about the NAIRU, and I think I made it clear on every occasion that I do not find it a very useful construct. I think the only country where it is taken seriously is the United States, and even there it let them down because it turned out to be lower than they thought it was. That was one of the big stories that evolved during the 1990s. I do not want to say any more about it other than that I do not think it is a particularly useful construct. I do not think I have ever heard it mentioned in the Reserve Bank board room. It is not something we use.

On the issue of what we would hope to do on the unemployment rate, I have always been a great supporter of the view that the best thing that monetary policy can do is try to achieve long expansions and stable expansions. They do not necessarily produce quick reductions in unemployment, but if they are done properly they can produce lasting reductions in unemployment. The real damage to the unemployment rate in Australia was done because we had three recessions, during which unemployment went up very sharply. It then took years for it to go down again. It was not that, when we grew, we grew too slowly; that is not our problem in Australia. Our problem was the sharp recessions and the fact that they came only six, seven or eight years apart.

The best thing any central bank can do to get unemployment down is to have long expansions. A lot of it is really just trial and error. In fact, that is how the Americans in the end worked out that their NAIRU was a lot lower than all the academics had calculated it to be. They just kept the economy growing, and they noticed that unemployment was coming down and that inflation was not going up. They did this year after year, and then they said, ‘Gee, that figure for the NAIRU must have been wrong.’ It was not because they had a really rapid expansion but because they kept it going and were comfortable to keep it going whilst there were no inflationary pressures—or only moderate inflationary pressures. They did put interest rates up sometimes and put them down, as we have, but over that decade, taken as a whole, they learnt that inflation could be lower because the expansion continued.

Dr SOUTHCOTT—I turn to that point that the unemployment rate is now where it was in June 1981 and also in 1989. We saw very rapid rises in inflation after those unemployment rates were reached. Does that influence the board’s thinking at all?

Mr Macfarlane—No. You have introduced an informal NAIRU there. No, that did not influence the board’s thinking.

Mr COX—You said in a press release of 3 December that ‘firming labour market conditions’ was one of the factors bearing on the CPI. You have discounted the NAIRU as a construct for dealing with that. Where do you see the firming labour market conditions as coming from? For example, is it skills shortages? Where is the inflationary pressure coming from?

Mr Macfarlane—If the economy is growing quickly and spare capacity is being used up—with other things being equal—that will at the margin cause some sort of inflationary pressures, whether you measure it from the output side or from the availability of labour side. Even though we do not have a magic number, we do accept that proposition. It is not severe. When some people look at the figures for wages growth, they say that they can see a gentle rise towards the end, but it is very gentle. We do hear a lot of stories about skills shortages. Part of this is a structural problem of not having enough apprentices in certain trades. We certainly know that some industries are running at absolutely flat out or full capacity; for example, the building industry. People have a lot of trouble getting builders. Within the building industry, we certainly know that the subcontractors’ rates are going up very rapidly, even if the numbers for wages are not going up all that rapidly.

There is, at the margin, some upward pressure on domestic prices coming from the fact that the economy will be growing at faster than the potential, so the output gap will be declining, and in some areas there are skills shortages. It is not very big at the moment. The aggregate numbers that are collected on this—the wage cost index—do not seem to be showing anything very dramatic. But at the margin, it is there. And it is the sort of thing that you have to think about if you are trying to make a judgment about where inflation will be in two years’ time or 2½ years’ time. If these sorts of things continue to build up at that rate, it would be a reason why you would be thinking of a higher rather than a lower number in two or three years’ time.

Mr COX—My next question relates to you continuing stance on monetary policy. You said in your press release that it is 'continuing to have a stimulatory effect'. In the next sentence you said:

The growth of credit remains rapid and indeed has picked up further in the past few months.

Is that rapid pick-up in credit growth mainly on the household side?

Mr Macfarlane—Yes. A debate will sometimes arise when we have said that we thought real interest rates were below normal or that they were exerting a stimulatory impact. Some people would try to dispute this. They would recalculate the numbers using different measures for inflationary expectations or try to introduce different assumptions into it and, somehow or other, dispute this proposition that we were putting forward, that the level of interest rates in Australia had been stimulatory. My response was always: 'Look, it doesn't matter what you think. What do the borrowers think?' It is pretty clear the borrowers thought that the interest rates were pretty low and they were very keen to borrow, and borrowing has been growing—or credit, the other way of looking at it—very strongly. In fact, credit continued to grow very strongly in 2003 and, if anything, was accelerating through the year.

You are right to say that the main influence on this was household credit. Total credit over the last six months has grown at 16½ per cent, which is a very high rate of growth of credit. For an economy where normal GDP is growing at six per cent, 16½ is a very high number. Household credit has grown 22 per cent, of which housing credit was growing at 24 per cent. And if you break housing credit down into its two components, you find that owner-occupiers borrowing for housing were growing at 19.9 per cent and investors were growing at 33.7 per cent. So it is the same old story, only at a slightly higher rate. I do not think anyone can dispute that borrowers thought that these interest rates were low and they wanted to build up their borrowing.

Mr COX—Are you sure that half a per cent is enough to change their behaviour?

Mr Macfarlane—That is a very interesting question; I thought we might get onto this at some stage. The actual squeeze that it puts on borrowers is not all that big, as you imply. On the average mortgage it is $60 or $62 a month more, or something like that. We know that half of the borrowers probably will not feel it at all, because they have been paying more than their minimum amount anyhow. It is not a very big squeeze on people, but in some areas it has already had quite a big impact on people's expectations about whether they want to borrow. It is not whether they can afford to; a lot of it is whether they really want to borrow at the same rate. If a lot of this borrowing was generated by housing, there is evidence that attitudes have changed to some extent—not a lot.

One of the things that I think has done a wonderful job in magnifying the effect of these quite small increases has been the behaviour of the spokesmen for the real estate industry and the builders, who for most of the year were telling everyone, 'Roll up. Prices are going through the roof. This is your last opportunity to buy.' There was a tiny rise in interest rates and they started saying, 'Why did you raise interest rates? You didn't need to, because prices were already going down. The industry was already in a parlous state.' It is amazing what a great job they have done in magnifying the effect of a small rise in interest rates in terms of influencing people's expectations about whether they really do want to go and build up their debt.

Mr COX—The other thing that has happened while we have been sitting here is that the Treasurer has released his midyear review of the budget. The expectation is for a surplus this year of $4.6 billion and for a surplus next year of $3.7 billion. Are you concerned that the government will do what it did before the last election and try and spend all of that? Do you think that will have any bearing on interest rates in the future?

CHAIR—Do you expect the first part of that to be answered?

Mr Macfarlane—This is a standard policy, when I come to this committee or talk to journalists, of trying to get a difference of opinion between the Reserve Bank and the government over fiscal policy. I can understand why people think this is a promising arena, because around the world there is a great deal going on. For example, in Europe at the moment we have the President of the European Central Bank berating the governments of France and Germany and saying that it is an absolute disgrace that they have allowed their budget deficits to blow out to a figure larger than three per cent of GDP, which has broken the Growth and Stability Pact which binds the European monetary system together. In the US, when Greenspan appears before a committee like this, a committee of congress, they are very keen to talk about issues of fiscal policy, because in the US we have seen that country move, in the space of about three years, from a surplus of two per cent of GDP to a budget deficit of five per cent of GDP. When I look at Australia and I put it in that perspective, I have got no problems at all. We have a small surplus in both years. The magnitudes are not big enough to have caused any concern for monetary policy.

Mr NAIRN—I will go back to the comments on household debt, and the effect of that half a per cent rise in the credit card area. There you are dealing with significantly higher interest rates. Do you think that that is having the appropriate effect as well?

Mr Macfarlane—I am not sure that I can answer that one, because I have not followed it; I do not actually know what the banks have done with their credit card lending rates. Even though it is a very interesting subject in terms of some of the things we will no doubt discuss later, in terms of its contribution to aggregate debt, credit card debt is tiny—as you would imagine—compared to housing debt. When we have talked about people taking on too much debt and credit growing too quickly, we have been talking about household debt, and 85 or 86 per cent of that is housing debt. I cannot remember what the figure is for credit card debt. I have quoted it in the past. It is something like six per cent, or it might even be lower.

Mr NAIRN—It is in that order?

Mr Macfarlane—Yes.

Ms BURKE—On that point, you seem to have spent a lot of time recently talking about the rapid growth of household debt in Australia. Your, I think, excellent submission to the Productivity Commission inquiry into first home owners, your annual report and your November statement have all laboured extensively on this household debt and the problem that it could cause. Do you believe that you have stemmed that risk of household debt or added to it through this rate rise?

Mr Macfarlane—I do not think we have done the second. In a sense, I think the problem was that it was too cheap and that was why people bought too much of it. If you put the price up, that has got to help in the long run. The question is whether what has happened to date is enough to cause a big turnaround. We do not know. We have people telling us that it will have no effect, and we have other people saying, 'It was too late. You didn't need to do it, because house prices were plunging,' and so on. We spent a huge amount of time following precisely this subject. We look at all sorts of minute data and talk to all sorts of people who run obscure research firms and so on in trying to get to grips with this. It is a very difficult subject to get to grips with. There is so much competing evidence. But certainly at the moment—just by looking at what has happened to credit in the latest published figures; we can also look at unpublished weekly figures that we get from banks—there has not been any change to it at this point.

Ms BURKE—Given that you also point out extensively that it is only 30 per cent of the market that is exposed to this debt—that there is only 30 per cent who have a current home loan—do you think we are putting a squeeze onto a very small section of the community that can afford to bear these rises?

Mr Macfarlane—The first thing is: that figure for 30 per cent is owner-occupiers. None of us really know what the figure would be if you said 'owner-occupiers plus people with rental properties'. We do know that there are a lot of people with rental property. It is unique to Australia. We have this huge body of people who have invested in rental property—the last estimate we had was about 1.3 million people. It is with that 1.3 million people where the rapid growth has occurred. I suspect it is in that group where we will find the most overextended people and where we will find that even modest rises in interest rates and falls in certain sorts of property prices—which have been going on for a considerable time; I was talking about this last time I was here—will cause distress. I do not believe the distress will be for owner-occupiers, although I do accept that people who have recently taken out a mortgage—the most expensive one they can afford—are going to be vulnerable. But they were always vulnerable.

It is like it was for any of us sitting in this room who, when we first took out a mortgage, took out the highest mortgage that we could afford: we were vulnerable in the first number of years until our incomes had risen or the mortgage had been partly paid down. I do accept that there are owner-occupiers who will be vulnerable, but I do not think they are the most vulnerable. I think the most vulnerable are the people who have done it for speculative purposes. There will also be some people who were not really speculators but were just legitimately preparing for their retirement and chose that as a means of doing it. They will be disappointed but I do not think they will be seriously harmed.

Ms BURKE—Do you think that we need to put greater supervision into the methods by which you can get financing? In the report of the Productivity Commission, on pages 49 to 50 you list the various instruments you can use to now go and get money. You can get money without actually having any money, which is a fairly scary thing—deposit bonds, interest only loans, loans with high valuation ratios. You list them and talk about them extensively in your submission. Given that some of these are not covered by APRA rules and regulations because they are not under the jurisdiction of ADIs, do we need to now put in a regulatory regime to stop such speculative lending?

Mr Macfarlane—I am not sure how we would handle this. For example, a thing which I think is going to cause a lot of grief—I have said this at this committee before and I have been criticised outside for saying it—is the deposit bond, particularly for people who used it to buy something that they intended to resell before settlement. I am not quite sure how you regulate a thing like that. It is an agreement made between consenting parties. Both sides seem happy with it. I am not sure how you would start to do that—although my understanding is that the use of those deposit bonds is shrinking at the moment and a lot of developers and vendors will not accept them as evidence of a deposit. In that sense, the industry itself is waking up to the risks that are involved there.

I am not really sure what you do with the new class of lender who makes the loans and does not actually hold the loan on their book but securitises them and sells them into the market. Some of these are doing a very good job, we know that—mainstream mortgage originators actually brought competition to the mortgage market in Australia, and no-one would wish to criticise them—but at the fringe there will always be some who are reckless. I am not sure how you handle that. I do not have a suggestion. I think APRA are working hard at trying to find whether there are practices within the institutions that they supervise and are looking at some of these issues, and they have found some practices that they were not formally told about: high loan to valuation loans without mortgage insurance. They are doing what they can. I suspect we will know a lot more about this in two years' time.

Ms BURKE—In a good way or a bad way?

Mr Macfarlane—Probably in a bad way.

CHAIR—One thing you cannot accuse the committee of is criticising what you have said here in the past. If there are no more questions on monetary policy, we might take a short break.

Proceedings suspended from 11.22 a.m. to 11.44 a.m.

Ms GAMBARO—Earlier on we were talking about auction clearance rates and you did not seem overly concerned. But in the context of the slowing of the trend for Brisbane to follow prices in Melbourne and Sydney, when we spoke at the last hearing you were concerned about unit developments and the proliferation of units in Melbourne. I have been following the real estate market quite closely. Why has there been such a dramatic increase in Brisbane? Is it just because it has been at a later stage, or is it because we have had a lot of investment from the south as well? What are your thoughts on that? What are your regional offices telling you? Is it because of the huge number of people moving here? Is population growth contributing to it? My colleague Alex Somlyay tells me that 1,200—

Mr SOMLYAY—It is 1,400 people a month.

Ms GAMBARO—are moving to the Sunshine Coast. So I am interested in your thoughts on that.

Mr Macfarlane—I am not a real estate analyst, so I am not sure that any account I can give you would be any better than what you might know yourself. The regional pattern throughout Australia is that the two slowest-growing markets are Sydney and Melbourne, and the fastest-growing markets are Brisbane, Adelaide, Canberra and Hobart, which is amazing. This whole subject of how fast house prices are growing is an interesting one. For most of the period of the housing price boom, no-one ever quoted anything other than the simple, standard series for house prices, of which there are three well-known ones. One is produced by the Real Estate Institute of Australia, and it has been going for a long time; another is produced by the Commonwealth Bank in conjunction with the Housing Industry Association; and the third is produced by the Australian Bureau of Statistics.

If these were the only things you looked at—and, by and large, these were the only thing that anyone ever did look at—you would still conclude that house prices are going up very quickly in Australia. The ABS says they went up by 17.6 per cent in the 12 months to the September quarter—that is their most recent figure, although that of course is getting quite out of date; the REIA says they went up by 15 per cent Australia wide; and the Commonwealth Bank says they went up by 28.7 per cent. So if you simply read the standard statistics, you would conclude that house prices are still going up very quickly in Australia, particularly in cities outside Sydney and Melbourne.

If you want better data and much more up-to-date data, you have to look at things like auction prices, which we do. But they are really only a good indicator for Sydney and Melbourne, because auctions are not very widespread at all outside Sydney and Melbourne, in which case you end up with very small samples that jump all over the place. If you look at auction prices—for example, for houses in Sydney and Melbourne—instead of 11 or 12 per cent growth, we are down to six per cent. If you look at that subset, over the last year—that is, the year to November—house prices have been growing by about six per cent. I am not really helping you much with Brisbane. I will have to come to that towards the end.

Ms GAMBARO—So there is no logical reason why these prices are patchy across Australia? I guess I am trying to link it to southern migration.

Mr Macfarlane—There are two things. I will continue running through some of these statistics. If you look at auction prices for apartments for the whole of Melbourne, they have risen by four per cent over the last year. But if you look at the latest monthly data, they are actually going down. If you look at auction prices for apartments over the whole of Sydney, they are still going up. In some months they go up and in some months they go down.

If you then concentrate on inner city apartments—and we are getting narrower and narrower—this was the most overheated part. This is where all of the negatively geared money went in. This is what the property seminar promoters were pushing people into. We have quite a bit of detail on those, particularly on Melbourne. If you look at inner city apartments as a whole, inner city Melbourne apartment prices have fallen by 9 per cent from their peak. If you break it down into particular areas, like CBD, Docklands, Port Melbourne, Southbank and St Kilda Road, each of those areas has fallen. Some of the falls are very large—20 per cent and 40 per cent for one area—from their peaks. So, when we narrow it down, we can find this in those inner areas. It is similar in inner areas of Sydney.

Before I get onto Sydney, I want to say something else about Melbourne. In Melbourne's case, the peak was often 18 months or two years ago. So, for inner Melbourne, the peak was in the March quarter of 2002. So the peak was nearly two years ago. In Sydney, the peak was much more recent. The peak was really in the June quarter of this year. But in Sydney we also have, for the inner area as a whole, a fall in apartment prices. So I think what has been happening is that, in the areas where there was the most speculative activity, where people were exploiting negative gearing and looking for profits—in many cases, quick profits through buying off the plan and reselling before completion—and where all of those excesses were occurring, in Melbourne those areas turned down probably 18 months ago and in Sydney six months ago. Those are the parts that the real estate people are now referring to when they are saying that prices are already falling. If that is what they are referring to, they are correct. They just did not talk about it before.

Then, if you spread it out for Sydney and Melbourne as a whole, I think the non-inner-city apartment area is still going up. It is not going up as fast as it did. The peak rate of growth was a few years ago. It is still going up, but it is probably decelerating—it is going up less and less. Then, if you move outside Melbourne and Sydney completely and go to the other capitals, I cannot see any evidence yet that they have slowed at all. They are growing very quickly.

It is almost as though it is something that is spreading from the centre. The parts that heated up first were inner city Sydney and Melbourne. They have passed their peak and they are in decline. Mainstream Sydney and Melbourne then heated up. They are still growing, but at much slower rates than at their peak. The other states, as far as we can tell, are still growing. We do not have as much information, so we probably could not judge as closely. But, from the aggregate figures we see, the other states are still growing.

Part of the Brisbane story or the Sunshine Coast story is that they are growing because they are not Sydney or Melbourne. Part of it may well be population. I am sure that, certainly on the Sunshine Coast, but in Queensland as a whole, there is probably an element of a population story in it as well. But prices cannot continue to go up at this rate. At some point they are going to slow down. The issue is whether they slow down or whether they fall. At the moment, the Queensland market is not in the mature or the terminal phase; it is still somewhere in the phase where prices are going up.

If I had the same amount of detail on inner Brisbane apartment prices, I might discover that the story there is not dissimilar to what it is in Sydney, for example. It would not have turned down anywhere near as early as Melbourne turned down. Maybe it is in the process of starting to turn down. But the rest of mainstream Queensland would not be in that phase, I do not think.

Ms GAMBARO—You cannot answer this question right now, but maybe your regional offices could have a look at it: how much of the activity in the housing sector is investment driven? It would be interesting to see. For some time, from my knowledge and from what I have been told by the real estate industry, we have had movement and growth in investment property. It would be interesting to see how much of the activity in the housing sector is investment driven and how much of it is coming from the south. I am not trying to be parochial and say that the southerners are causing all these problems, but it would be interesting to see how much of it is interstate activity.

Mr Macfarlane—The figures which break it down into investor as opposed to owner-occupier are not all that good. The banks, on lending, can tell you, because when you make the application that is one of the pieces of information that they automatically get because they want to know what your collateral is. If you have already got another home, they know that that is where you live and therefore this one must be an investment property. If you went to developers, they often would not necessarily know. They sell the thing and they are not interested in whether it has been bought to live in or to rent out. I think it might be difficult to get that sort of information that you want.

Mr SOMLYAY—I have a question on the same issue. I have really no concern for speculators, because basically they are punters. I have concern for investors who invest as a long-term proposition, but the people I am really concerned about over interest rates are the people who live in the mortgage belt. They own a house. They are not buying and selling property. They are hit now with a $60 interest bill which reduces their household budget. That comes out of the household budget purchasing power. What impact is it going to have on the economy when so many people have that money, which normally would go into household expenditure, taken out of the household budget and going to the banks instead?

Mr Macfarlane—I suppose the only thing that I can say on this is that we have got to remember that only 30 per cent of households in Australia have a mortgage. Forty per cent own their own house outright and 30 per cent are renting. Of that 30 per cent who have a mortgage, a lot of them took the mortgage out some time ago and so their income has risen in that time and the mortgage has been paid down. It is really only the people who have just taken out a mortgage who are the ones who feel it, because the mortgage is high relative to their income. But this has always been the case. Ever since any of us can remember, in each particular year there is always a group of people who have just taken out a mortgage for their own home and they feel a bit of a squeeze when interest rates go up. Of the people with a mortgage, somewhere between 50 and 60 per cent probably will not actually have their weekly payment go up, because they are already ahead on their repayment schedule. So, rather than 30 per cent, it is maybe 15 per cent of households that will see their monthly mortgage payment go up. I feel sorry for people who have just taken out a mortgage and interest rates go up, but you cannot really make economic policy on the basis of that.

Similarly, when we were putting interest rates down, I had a lot of letters from self-funded retirees saying: ‘This is really going to be tough on us. We are going to have to review how much money we spend on our food and how often we go out, because we are living on fixed deposits and you have put the rate down. Our income has gone down.’ So there are people—not a lot, but some—at the margin who are going to be vulnerable to either a rise in interest rates or a fall in interest rates. We should feel sympathetic to them, but at the end of the day we have to make the monetary policy decision on what we think is best for Australia.

Mr SOMLYAY—Banks are very quick to put interest rates up; they pass the increase on very quickly. But, when interest rates go down, they are a little reluctant to pass that on straightaway. Do you have any comment from the point of view of the Reserve Bank?

Mr Macfarlane—I am not up to date on this, but my memory is that what you described used to be the case and it was asymmetrical. However, over recent years banks have tended to pass on mortgage rate increases and decreases within one or two days of our changing interest rates. I think what you describe is no longer the case. Is that right, Ric?

Mr Battellino—That is right. There was a period in the first half of the 1990s when banks were very slow to pass on reductions in rates but, since then, the lags for both reductions and increases have come much more into line and are much shorter.

Mr SOMLYAY—I think your message on the building and construction industry is pretty clear!

CHAIR—In the past, you have talked about margins falling. The committee certainly welcomed that, and in the past we have brought to your attention some sectors that were a bit slower than others to see the margins falling. With interest rates rising, one of the majors was quoted recently as saying that their margins are normally higher in higher interest rate environments, and one of the smaller banks was apparently quoted as saying that rising interest rates would actually add to profit this year and that every 25 basis point rise in rates added $2 million to this particular bank's profit. In the light of your previous comments on this, do you have any comment on the fact that the banks seem to see rising interest rates as a way of raising margins as well?

Mr Macfarlane—There are two dimensions to this. When interest rates started going up, the analysts out there started selling bank shares. Their view was that higher interest rates will slow down the growth of credit and, if the growth of credit slows down, bank profits will decline. It is quite clear that one of the reasons bank profits have been so high is because of this rapid growth of credit. The banks have been the big winners out of this rapid growth of credit. If it slows down, bank profits will not be as high. Against that, there is the second issue of the margins. Historically, banks' margins have widened when interest rates have risen and they have contracted when interest rates go down. The reason behind that is that banks have always got a certain proportion of their deposits at zero interest. Many years ago, for example, all cheque accounts used to be at zero interest. Therefore, the higher interest rates were, the more valuable it was that a proportion were at zero interest rates. So, you are right: banks' margins widen slightly when interest rates rise, but it does not necessarily mean their profits will rise. Their profits could fall because their lending activity will fall.

CHAIR—I am just wondering aloud whether cheque account fees might start dropping on that basis. Do you have any comment?

Mr Macfarlane—I am sorry, but we cannot really provide you with much help on the bank fees issue. We do a study or a collection once a year, and that is usually published shortly before the mid-year meeting of this committee. We do not have any new information to provide to the end of year meeting of the committee.

CHAIR—Having said that, Mr Macfarlane, with the Payment System Board being part of the Reserve's responsibility, I would like to get onto the area of credit cards. I think we really ought to explore credit cards a bit further because there have been some very interesting developments. We have talked about the interchange fee in the past—that has been ongoing. You have made comments in the payment system report that the court case has now been concluded or that the appeal has been dropped. One of the questions I have concerns a recent BIS Shrapnel analysis on the rise in credit card fees. They pointed out that the increases in loyalty points needed to redeem rewards have led to an increase in the cost of holding a credit card of between 35 and 75 per cent. In their opinion, this would offset the reduction in credit card interchange fees. I wonder what your response to that might be.

Mr Macfarlane—The reason we got interested in credit cards was that we concluded they are, for the community as a whole, the most expensive way of making a payment. When I say the community as a whole, I mean both cardholders and merchants—in other words, the non-bank part of the community. There was a bigger transfer from the non-bank part of the community to banks as a result of a credit card transaction than as a result of cash, cheque, an EFTPOS card or a direct credit. That is why we got interested in it. When you looked at it, you realised that the reason there was such a big transfer was that the money really came from the merchants in the first instance. The interchange fee and the merchant service fee are where the banks get their big money from credit cards. Their marketing strategy was to make it as cheap as possible for the cardholder so that the cardholder would want to use their credit card all the time. Therefore, each time the credit card got used, the merchant would have to pay over a significant sum of money to the banks. That was the marketing strategy. We did not like that strategy because the cardholder was not seeing the true cost of what they were doing. The cardholder was saying, ‘I’ll do it this way because it is cheaper for me, even though it is more expensive for the community.’ That was the basis of our worry about the way the credit card system was working. As a result of incentives to make it cheap for the cardholder, credit cards are growing faster than any other form of payment system.

One of our aims has actually been to try and make the true cost visible to the people who are making the decision as to whether or not to use a credit card. We have reduced the interchange fee, which will reduce the cost to the merchant. It is true that the banks, seeing that source of income go down, are to some extent compensating by charging the cardholder. That does not actually worry us. In fact, we would actually like to see—though we never will—a small transaction charge on the credit card, because you actually pay a little every time you use any other payment system. Every time you get some cash out of the bank, whether it is from the ATM or from standing in a queue, you have to pay. When you write a cheque, there is a transaction fee for writing that cheque. With EFTPOS, there are a few free transactions, but once you get past that you have to pay a fee. And for direct entry you have to pay a fee. The one payment method where the initiator of the transaction does not have to pay a fee is with a credit card. It is designed that way to get them to use it, because that is the one where the banks are going to make a lot of money.

If the banks have actually reduced the cost to the merchants somewhat, as a result of our initiative, and if they get some of that back by making the cardholder pay some money in the form of an annual fee, then that does not particularly disturb us. In fact, we would like to have seen the cardholder actually have to pay a small transaction fee. But that is never going to happen because the marketing strategy is to keep the transaction fee at zero. So part of the rebalancing, part of bringing the credit card more into line with the other payment systems, actually does involve the cardholder having to pay some of the money.

CHAIR—I do not disagree with what you are saying in principle, but in practice one would question whether there are competitive pressures in place for a more efficient system. You are saying that the fee pressure should be on the banks and they have been trying to put it back onto the merchants, but I will give you an example of a credit card fee increase from the beginning of this month on a cash advance fee of one of the majors. It is a simple example. If you had an opening balance of $400 in debit and you made three transactions on the day: a payment to your account of $800—in other words, you put it back into credit—a purchase of $50 and a $200 cash advance, the purchase and cash advance will be posted to your account before the payment is, even though physically you may have done it the other way around. You will therefore be charged $3 for the cash advance.

Mr Macfarlane—I do not think that is an issue that is necessarily particularly confined to credit cards. I think what you are saying is that the banks have an infinite array of ways of putting on a fee or changing the timing of something so it works out profitably for them. I do not dispute that. I do not think this is specifically related to credit cards.

CHAIR—No, but the principle is whether the competitive pressures are really working.

Mr Macfarlane—In some areas competitive pressure has been very effective—go back to the mortgage originators. I think the answer is: if that competitive pressure comes from someone outside the industry, it is very effective. If you can open up access so that it is not just the members of the club who are competing with each other but that someone from outside who has got nothing to lose can also compete, that is where you get very beneficial results. Part of our reform is to try to open all of these—ATMs, EFTPOS and credit cards—to outside competition, and that is where we will eventually, I believe, get a big payoff. I do not know who this big outside competitor is going to be—I do not know who the Aussie Home Loans of the credit card industry is going to be—

CHAIR—We have seen Virgin credit cards.

Mr Macfarlane—Yes, that is an example of competitors coming in. John, could you say a bit more on the potential for outsiders to come in? You are a little bit closer to this industry than I am.

Dr Veale—On both sides of the credit card market, if you look to other countries, you find that on the merchant acquiring side there are firms that have recognised that this can be a profitable business. In the United States you find that non-traditional players do the majority of the acquiring business in one way or another.

Mr Macfarlane—You need to tell people what ‘acquiring’ means; it is a very confusing word.

Dr Veale—The acquiring business is the business of servicing merchants—providing credit card services to merchants. In the United States over the last 15 or 20 years the experience has been that the non-traditional players—people who specialise in that business—now do more than half of it. They are not traditional banks.

Mr Macfarlane—They are not banks at all.

Dr Veale—No. On the issuing side, you find there are specialists who have developed who are able to specialise in the business of credit cards, and, again in the United States, a lot of credit cards are now issued by those specialists. The same sort of thing is happening in the United Kingdom. Some of the important parts of the reforms we have introduced will allow those sorts of organisations to become members of the credit card schemes. They will be prudentially supervised by APRA and eligible to apply for membership of the credit card schemes. That will not happen overnight, and in this area you need to be a little bit patient to see the effects of increased competition. But that will give some options to organisations that want to get into this business to be able to seek out the profitable parts of the business, because what you are really saying is that these parts of the business are profitable to banks and the aim is to provide competition from outside to the extent that it does not occur from the current players.

CHAIR—The reason I am pushing this is that I want to know how confident you are that this competition will really work. There was an article in the *Economist* a few months ago talking about the Wal-Mart class action against Visa and MasterCard—these people are not small players. The interchange charges for offline payments have cost retailers perhaps $US4 billion a year more than online payments. The article goes on to say that this case took many years to get up and that it was very hard to prove that consumers are disadvantaged by hidden card charges. This is the point. It is quite a complex area, I appreciate that, but I wanted to know if we are getting to the point where there is a competitive, transparent market.

Mr Macfarlane—The case that you are referring to, with Wal-Mart representing the retailers or the merchants of America versus Visa and MasterCard, was against a particular form of behaviour which was remarkable. I would have thought it was more against the public interest than anything that has happened here. In that case, a merchant who wanted to accept, say, a Visa credit card was also forced to accept a Visa debit card. A Visa debit card was about five or six times as expensive to the merchant as the ordinary debit cards that were circulating in the banks in that region. Visa and MasterCard used their market power to force merchants to accept this thing. That is where you got that $4 billion or so from: that is how much more it cost them to accept that card than the ordinary cards that everyone had always been using.

It seemed to me that that was a particularly naked use of market power against the interests of the merchants in particular. Again, it did not hurt the consumer; the whole aim of that thing was to make it cheap for the consumer so the consumer would use it and then to slug the merchant. It took so long for the American courts to reach a conclusion. In the end they did not reach a conclusion; the case was settled out of court. It involved Visa paying $2 billion and MasterCard paying $1 billion to the merchants for that behaviour. We hope that we can do these things more directly than having a court case that lasts six years, as it did in the US.

Mr NAIRN—On your earlier comment that you would like to see a transaction fee on credit cards, presumably, if that were the case, you would be looking at reduced costs elsewhere in the process. I noticed in a report in the *Financial Review* last month that some of the research—admittedly commissioned by Virgin Money—by BIS Shrapnel showed quite significant increases in effective costs to credit card holders in the last couple of years. It found that people who actually pay off their balance had a 75 per cent leap in the cost of credit cards since 2001, compared with a 35 per cent jump for ‘revolvers’, people who do not pay the balance off. They are quite significant increased costs. Have you got any comments about those?

Mr Macfarlane—The first thing is that the thing about transaction costs was just a private view. It is not part of our public policy program; it is just letting you know that that is the way the system works. There are basically five payment streams. There is a transaction cost on four of them, and there is one where there is not a transaction cost. It is obviously a very deliberate marketing decision to keep that transaction cost to zero. The card holder was basically getting massively subsidised, particularly the card holder who had never borrowed. They were getting 55 days free credit for nothing, and that subsidy was being paid for by the merchants of Australia. What is happening now is that the merchants are not paying quite as much, and, as a result, the banks have chosen to reduce the subsidy that was built into the credit card. They are still being subsidised, but the subsidy is not as big.

Dr Veale—Can I add one small thing?

Mr Macfarlane—You will probably correct my economics, but go ahead and do it!

Dr Veale—In that repricing it is interesting that, if you look at most of the banks' card schemes now, you will see that the biggest increases in charges are for people who are attached to loyalty schemes. Instead of the people who were on loyalty schemes being subsidised by the general public through the charges to merchants, they are now paying. If you do not want to be in a loyalty scheme you get your credit card cheaper. It is putting the charges where the benefits are.

Ms BURKE—Do you have a response to the assertion by MasterCard and Visa that the RBA's reforms have created an uneven playing field and that the closed card schemes—that is, Diners and Amex—have now got a benefit out of your reforms?

Mr Macfarlane—If we had simply reduced the interchange fee on Visa, MasterCard and Bankcard, and done nothing else, that would be a legitimate criticism, but we did one other very important thing: we ended the prohibition that the schemes put on merchants passing through their costs. It is up to merchants. Many of them choose not to, but they can pass through their costs. The three-party schemes are more expensive to merchants than the four-party schemes. At the moment the merchant only has the choice of either not accepting or accepting the three-party cards. Many of them do not accept the three-party cards. Now that the merchants have the additional choice of accepting the three-party cards—Amex and Diners—and because it is more expensive for the merchant, they can charge the customer more for using the expensive payment system than for using the cheaper one.

If the system works and as transparency becomes more and more common, which will take a long time, then the three-party schemes will not have an advantage. Our understanding is that in the US, where there has been competition between four-party and three-party schemes, the effect has been that the three-party schemes reduce their fees. It takes a long time but they eventually reduce their fees because of merchant resistance.

Ms BURKE—Now that the credit card reforms are out of the way, are you going to look at other areas where there is concern about interchange fees, particularly in the area of BPay?

Mr Macfarlane—We did not include BPay in our original study because it is still extremely small. It was really tiny when we started. The figures showed that the average bank customer had three BPay transactions a year whereas they had 50 or 60 credit and debit card transactions a year. So BPay was a very small thing. It is growing. We are talking to the banks about BPay and we will do a thorough study of the economics of BPay to see whether we think that the interchange fee is reasonable or, indeed, whether there should be an interchange fee at all. We will certainly look into that.

Ms BURKE—Given that banks are now deriving such an enormous amount of their profit from the fees and charges, and you said that probably a better way to go with the credit card was to have a fee, do you think it is time to get a directive from the Treasurer for somebody—I do not care which authority it is: you, ACCC, ASIC or somebody else—to have the authority to monitor fees and charges and the impact that they are having on transactions and household debt and credit? As David pointed out, every time you put money in or out you are being charged for it. I am not sure if everybody is fully aware of what it costs them to do their transactions with banks.

Mr Macfarlane—We have done our best, and this committee has done a very good job of highlighting this and getting research done on it. Our feeling is that, in the long run, the more we can get competition from outside banking into those areas of banking that are super profitable, as mortgage lending was, the greater our chance of getting a final solution. I would not support, and I do not think there is much likelihood of, some directive being given that says, ‘This fee shall be this and that fee shall be that.’ I do not think we are going to go down that path.

Dr SOUTHCOTT—The bank has said in a statement that it is confident that the lower fees will ultimately flow through and reflect the prices that consumers pay. Has the bank done any work on whether this will have a measurable impact on the CPI? Or is it quite small around the margins?

Mr Macfarlane—It is quite small, I am afraid. Let me think. I have quoted the arithmetic a few times. I do not have it at the top of my head. Do you have the arithmetic, John? Basically, to the merchant, if the interchange fee comes down—it has almost halved—if it has gone down by, say, 0.4 or something like that on credit card purchases, and credit card purchases are only—

Dr Veale—A third, or something like that.

Mr Macfarlane—a third of purchases, it is really a third of 0.4. It is not something that you would readily be able to monitor. Most economic changes are like that; most of them involve very small changes at the margin that just accumulate over time, and that is how we get efficiency. But, to answer your question, that is why we said we were not going to try to monitor it by actually looking at CPI and seeing the effects on the CPI. Instead, we are monitoring it by finding out how much the merchants are paying in merchant service fees to banks.

Dr SOUTHCOTT—Was the problem that we have seen quite a large shift in the proportion of purchases that are done through a credit card because of the way the loyalty schemes were working and so on?

Mr Macfarlane—Certainly they grew faster than other payment streams; that is true.

Ms GAMBARO—Governor, continuing on ATM fees, in 2003 you were talking about concerns you had with interchange fees, particularly in the ATM network. You wanted some more transparency. I think in March you had a working group that was made up of banks and other people to look at that transparency. How is that going, particularly with the foreign fees when you are using an ATM terminal other than the designated bank’s terminal? Some of those charges can be quite horrendous.

Mr Macfarlane—I am not involved in that working party. John, you would be closer to it than I am.

Dr Veale—The current problem is, of course, that somebody wanting to use a foreign ATM—that is, an ATM that is not owned by your own bank—ends up paying a foreign fee but normally they do not know what that fee is until after the transaction has taken place, at the end of the month when they get their statement. The proposal that I think will be put to the ACCC by the banks very shortly is to eliminate the current interchange fee of about a dollar which underpins the average foreign fee of about $1.35. So those two things would disappear. If you used a foreign ATM the owner of the foreign ATM would have a sign on the foreign ATM to say, ‘This is how much it costs to use this ATM.’ That would be debited to the account of the person making the withdrawal. It may also be the case that the cardholder’s bank also charges them whatever their transaction fee is as well, but they do that at the moment anyhow.

The plan is to get some competition and transparency into this so that when you went to an ATM you would see what the charge is and you could decide to make the transaction or you could make the transaction at another ATM which was providing a cheaper service. At the moment, you have no choice at all. You go and you pay a foreign ATM fee and there is no competition influencing those ATM fees, which is one of the problems that people have been talking about. This is a proposal that would actually introduce some competition into that market.

Ms GAMBARO—It is a good idea to display it. Thank you.

Mr COX—I wanted to ask a few questions about the relationship between the government and the bank. The Treasurer this morning released his mid-year economic review, and he said that inflation will go down to two per cent in 2004-05 and then come back up to about 2.5 per cent in 2005-06 and 2006-07, which is broadly consistent with what you were saying about inflation being on an upward trajectory in 2005. Do you still have a joint economic forecasting group where the Reserve Bank has a considerable degree of influence on the government’s forecasts?

Mr Macfarlane—We still have a group that has been going for a long time. It has changed its name about three times. There still is one. I am not sure how far out that particular group forecasts for inflation. Do you know, Malcolm?

Dr Edey—It is normally 1½ to two years ahead. I think the latest MYEFO that has come out will have been revised subsequent to the latest meeting of the joint economic forecasting group.

Mr COX—So they will be Treasury’s forecasts rather than JEFG’s forecasts?

Dr Edey—MYEFO is a Treasury document.

Mr COX—The statement on the conduct of monetary policy was revised slightly at your reappointment. The only difference that I could see from reading that and the previous one was the deletion of the passage that stated: ‘However, the government will no longer make parallel announcements of monetary policy adjustments when the Reserve Bank changes the overnight cash rate. This will enhance both the perception as well as the reality of independence of Reserve

Bank decision making.' Was that simply an expiry of the relevance of that because there had not been a situation of parallel announcements for some time, or was there some deeper meaning in it?

Mr Macfarlane—The first explanation is right. It had to be said the first time because the practice had run up until that point. When the practice was discontinued, as it was essentially when I became governor, we no longer had to say a second time that it had been discontinued because it had already been discontinued. So that was simply a matter of an update. That sentence no longer contained any relevant information. It was not a change in policy.

Mr COX—The government still reserves its right to comment. Now it is no longer the case that the government makes parallel announcements. It occasionally makes contradictory ones. For example, when interest rates rose the first time, in November, the Prime Minister said, 'I don't think there is a case for any significant increase in interest rates.' Do you find it a little bit frustrating that you are trying to get a clear message out to the markets and the community about the direction of economic policy and give them some indication of what your thinking is so that they can respond in an intelligent way, and the government—when it suits it—chooses to contradict you?

Mr Macfarlane—I am not sure that they contradict us. I think sometimes they distance themselves from the decision. That is just the way the world works. That particular statement that there was not a case for a significant rise in interest rates is something that I may well agree with—it all depends on how you define the word 'significant'. In that sense, I think the statement was carefully thought out.

Mr COX—Do you have conversations with the Treasurer before or after you have moved rates?

Mr Macfarlane—We have a regular pattern of a meeting with the Treasurer after our board meeting to explain to the Treasurer what went on in the meeting and to generally go over the economy and talk about threats, risks and what have you. If we are going to put to the board a recommendation for a change in rates, it is contained in a board paper, and the board paper is sent to the Secretary of the Treasury as a member of the board. He would talk to the Treasurer so that the Treasurer would be informed about what was going to the board. On some occasions the Treasurer may wish to speak to me; on other occasions he may wish not to.

Mr COX—Have you ever sought a meeting with him and had it declined?

Mr Macfarlane—No. These things would happen over the phone anyhow, probably. That has not happened. Sometimes meetings have been cancelled from either side, but we have never sought a meeting and been declined.

Mr COX—Recently?

Mr Macfarlane—No. If you are referring to the monthly meetings we have after the board, I would say that, in any given year, two or three of them do not happen for some reason, usually because the Treasurer has some other engagement that has cropped up. But that happens every year.

Ms BURKE—Are you currently happy with the composition of the board?

Mr Macfarlane—Yes, I am. As you know, our board is unusual by the standards of most central banks in that it is a lay board and yet it is a decision-making board. It is not just a group of economists, and I am comfortable with that.

Ms BURKE—Do you think there needs to be greater expertise on the board—besides your esteemed self, of course?

Mr Macfarlane—There are some people who do. We are getting back to the issue of whether it would be better to have a Bank of England type model. My view is no. I do not know what you would do if you started with a blank sheet of paper, but we have a history of this type of board and it has got widespread acceptance that you have non-technical people on the board. I think in Australia people take comfort from the fact that it is not just a lot of high priests sitting up there making this decision, that there a practical people who have to be persuaded and who come at the issue from a different direction. I think that gives it strength.

Ms BURKE—Are you happy with people's attendance at board meetings?

Mr Macfarlane—Yes, attendance is pretty good. In fact, we publish the attendance in our annual report and it is generally very high. I have to tell you that it is much higher than it used to be. If you went back 10 or 20 years, the attendance was never as good as it is now. People take their responsibility seriously.

Ms BURKE—I am going to change the subject completely. At the last hearing we were talking about the Henry Kayes of this world and the lack of regulation in that area. Since that time—and I remember your wise words at that hearing—Henry Kaye has gone under. Are you aware of an ASIC report on property investment promotions, which I understand has not been publicly released? Has the RBA been consulted on this report, given the impact of property investor promotions on housing prices? Could you speculate why the report has not been released, if you know of it? Given your comments at the last hearing, would you say that there is still a need for both Commonwealth and state regulation of this area?

Mr Macfarlane—I am not aware of that report's existence. Given that I was not aware that it exists, I have obviously not been given the opportunity to see it. I have had informal discussions with the head of ASIC, David Knott, from time to time at our regular meetings of the Council of Financial Regulators. He knows what my views are and I know that he is also concerned about that particular sector. I think at the end of the day ASIC did a good job. Basically, ASIC closed down Henry Kaye. He did not just fall over; it was the fact that ASIC instructed that company to reimburse people who had signed up under false pretences that was the crucial event. At the end of the day, ASIC comes out of this with a fair bit of credit.

I am not sure what the final solution to the problem should be, whether it should occur at the federal or state level. But there has to be a means of regulating people who are essentially giving financial advice. They are saying: 'Invest in this class of asset; not that class of asset. Structure your financing of it in a particular way so you maximise your tax benefits.' They are definitely giving financial advice. They are not real estate agents. I think the industry originated from the big real estate firms who started this business of running seminars. Meriton, Mirvac and others started the business of running seminars simply to promote real estate. Then it widened to people who were not actually real estate developers but were simply people who were making money out of giving financial advice and in many cases were very severely conflicted, because having encouraged people to buy a property they then said, ‘You should buy it off me.’

I think it has been a big problem. Whether it still is I do not know, but it may well be that not just Mr Kaye has shrunk. I would suspect that many other firms in that industry are also finding it very hard to find people to attend their seminars. I do not know because no-one knows anything about that. It may well be a problem that has gone away for the time being, so the solution is not urgent, but I think in the long run we do need to find a solution so that people who give financial advice are treated equally.

Ms BURKE—One of the investment tools that these seminars were using and that you point out in your report is a thing called a ‘low documentation loan’. It is fundamentally a loan that does not require you to demonstrate that you actually have any assets, income or anything, so it is pretty cute. Is the RBA concerned about the rise in low document loans and reverse mortgages, giving householders a greater access to easy credit? Do you think there may be some systems of tax avoidance in these schemes, by virtue of people not having to declare the sort of income they have to access these loans? Are you aware of a draft consultation paper from APRA, taking away the preferred capital treatment given to some home loan products, and are you in support of these regimes?

Mr Macfarlane—To answer the third one first: yes, I am aware of that and I do support it. With respect to the issue of the growth of the low doc lending industry, it is not as though there is no documentation. My understanding is that there will often be documentation about assets but there is no proof of income. Because there is no proof of income, there is widely held suspicion that it is actually a form of money laundering. In other words, people who are underdisclosing their income to the tax office then give a different figure to the lender, and the lender lends on the basis of that different figure, in which case it could well be an issue for the ATO. I do not think lenders would lend on no documentation. I think that basically they want documentation about collateral but they do not ask for documentation about income.

Mr SOMLYAY—How do you think the appreciation of the Aussie dollar is going to affect the dividend that you pay to government?

Mr Macfarlane—The answer is that it is not, in the short run. It is true that our intervention in the foreign exchange market is profitable. We were buying the Australian dollar at 50c and 47c—that is, selling foreign reserves and buying the Australian dollar—and now we are selling the Australian dollar at 73c, so obviously money is made on doing that. But you have to recognise that, the way the accounting for the Reserve Bank is done, the profit is not realised until we actually sell the foreign currency. The profit is realised when we sell foreign currency, not when we buy it. That means that the profit is actually realised during the periods when the Australian dollar is weak, when we are selling foreign currency to buy Australian dollars. We can re-establish a profitable position when the Australian dollar is strong, but it is only an unrealised profit. It becomes a realised profit when we sell the foreign currency.

Mr SOMLYAY—Mr Backer from the Association of Independent Retirees asked me if I could raise an issue with you regarding your speech to the Melbourne Institute's Economic and Social Outlook Conference.

Ms BURKE—That was a very good speech.

Mr SOMLYAY—You made some remarks about retirees. One of the things you said was that we should give priority to tomorrow's working age population rather than satisfying the demands of yesterday's grey-haired generation. He asked me to raise this issue with you. Do you want to comment on that remark?

Mr Macfarlane—I have got into a lot of trouble over that speech. Everyone thinks it is directed at their age group. A lot of the press said it was an attack on the baby boomers, which is my age group. The current retirees, who are older than the baby boomers—they are the previous generation—think it is an attack on them. A number of people from generation X have also written letters to me asking how I dare say these things. It was not—let me reassure the self-funded retirees—a call to withdraw any privileges or any government support that retirees currently receive. It was, however, a warning that we should be very cautious about handing out any more potentially expensive forms of support for retired people, particularly forms of support which will have to be financed from general taxation. It was all very well to do this when each successive generation was much bigger than the last one, but it becomes very difficult and very demanding if the next generations are not as big as the ones they are supporting, or as not as big by as big a margin. So it was not a call for withdrawal of any of the existing wide range of protections and subsidies that exist; it was a warning that it would be unwise to add to them.

Ms BURKE—Do you have some warning, then, given the blow-out in household credit and the lack of savings of most generations who are currently still in the work force? Every report that you have put out recently highlights the debt scenario that people are going into. I suppose on the flip side, only stated in a minor way on occasions, is the absolute lack of savings that the Australian economy and that Australian society have.

Mr Macfarlane—I have expressed concerns about the rate of growth of borrowing and lending. That is what I have expressed concerns about. I have felt that it cannot continue to grow like this. An economy that is growing at six per cent in nominal terms cannot have credit growing at 15 per cent, and it cannot have household credit growing at 22 per cent. Something has to give at some time. So I have certainly expressed that view on many occasions. I am not sure that I can go much beyond that. I do not think I can then say, 'Let us now put in place a set of policies to raise the household savings rate.' I do not think that there is any politically feasible set of policies that would achieve that, just as some people say it is very hard to think of a politically feasible set of policies which would materially alter the birth rate. So I am not campaigning to put in place a set of policies aimed at raising the saving rate. I think it will rise at some point. I think a lot of the excesses we have seen with this credit growth will turn around and, when that happens, I think the savings rate will probably go up a bit. That will mean weaker consumption. Consumption has been boosted, undoubtedly. We have written a big article on how consumption has been boosted over recent years by this concept of housing equity withdrawal. These are very interesting subjects, but, apart from the fact that I think the savings rate will rise again for cyclical reasons, I do not have a set of policies I want to propose.

Mr COX—You do not see an increase in private savings in the short term. You have said you are fairly relaxed about the situation with respect to public savings. You would even be relaxed if there were slightly less public saving than there is now. What do you see as being a solution to a current account deficit that is over six per cent?

Mr Macfarlane—I think the reason the current account deficit is over six per cent is, like a lot of other things, due to the fact that we have grown a lot faster than the rest of the world. That is the biggest single reason. That is a cyclical event. We will not continue to be able to grow this much faster than the rest of the world for the simple reason that the rest of the world is picking up. The fact is that when the rest of the world's growth picks up, and particularly when our rural exports pick up—and they are going to pick up by a very big margin—I think we will see the current account deficit come down again. The six per cent that you refer to is a peak which we have had on four or five occasions. It is not as though there is a trend deterioration. There is a cycle around a flat trend.

Mr COX—The methods of getting down from it have been unpleasant on a couple of occasions and have been more gentle on others.

Mr Macfarlane—The example that I am referring to at the moment is the fact that the world economy is picking up, and it definitely is, and that is going to start to feed through to us, and that our rural exports will pick up. They are both pleasant ways of getting the current account deficit down. I am aware of the fact that in the past it has often fallen because there has been a sharp reduction in domestic demand, but we do not envisage that as being the mechanism on this occasion.

Mr NAIRN—Will the world growth be at a rate to counteract, from a rural export point of view, the increase in the Australian dollar—in general terms?

Mr Macfarlane—I do not know. You are really asking me to forecast commodity prices and, apart from making the observation that I think they are all clearly under upward pressure, I do not know that I can be more specific. I do not think it is going to be one for one. What tends to happen is that when the world is weak in commodity prices the Australian dollar falls somewhat, and when the world is strong commodity prices rise and the Australian dollar rises somewhat. So it takes out some of the variability in export receipts but I do not think that it actually takes all of it out.

CHAIR—Mr Macfarlane, in the annual report you talk about the regional offices, and I think it also gets a mention in monetary policy, and yet in the monetary policy statement there is not a lot of discussion about regional differences. Given that the US Federal Reserve has its beige book, which you will probably aware of, which does go into a bit more detail, have you thought of expanding the reporting from the regional offices to give a bit more of that different flavour across different parts of the country?

Mr Macfarlane—We have thought of it but we really have not done it. One of the reasons is that in Federal Reserve system the districts, and I think there are 12 of them—the regional Feds, they are called—are very big organisations. They have a couple of thousand staff in each one of them and they do bank regulation, cash distribution and a huge amount associated with the antiquated system of cheque clearing that they have in the United States. They are really quite large organisations and they can support a body of economists—there are perhaps a dozen economists in each one—and it is a massive infrastructure, which we do not have. I think it would be a bit ambitious for us to do anything that resembles what is in the beige book. But I take your point that maybe we should make more reference to regional differences where the regional differences are significant enough to influence our interpretation of how the national thing is moving.

CHAIR—If there are no more questions, I think we might wind it up. I would like to thank everyone here today, particularly the Governor and other members of the Reserve Bank. I thank my colleagues and the media. I think it has been a particularly valuable public hearing. There has been a wealth of information given today and I hope that it will continue to reflect positively on the way that our economy performs. Thank you.

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

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

Committee adjourned at 12.55 p.m.