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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2002-03

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SYDNEY

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 4 June 2004

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: Mr Albanese, Mr Cox, Mr Griffin, Mr Hawker, Ms Gambaro, Mr Nairn and Dr Southcott

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2002-03.

WITNESSES

Committee met at 10.00 a.m.

BATTELLINO, Mr Ric, 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, Head, Payments Policy Department, Reserve Bank of Australia

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration and welcome representatives of the Reserve Bank, students and staff from the universities and secondary schools in the Sydney area, members of the public and the media. I think we have about 12 schools here, which is great to see, and I hope that the students really do get something worth while out of this. I have had very good reports in the past from students and their teachers; I am sure today will be equally rewarding.

Today's hearing is significant in that it will be almost certainly the Reserve Bank's last appearance before the committee prior to the pending federal election. The hearing today comes at a time of no change in interest rates for six months. This follows two rate rises in late 2003. Since then the RBA has held rates at 5.25 per cent. Clearly, the committee is now interested in the governor's views on the pressures facing the Australian economy, our relative performance compared to other economies and the possible direction of interest rates. Of significant interest is the latest Reserve Bank survey revealing that Australian banks earned $8.7 billion from all fees in 2003 and two-thirds of those fees were paid by business. The committee notes that credit card fees, excluding interest charges, jumped 38 per cent to $604 million last year. By comparison, home loan fees only grew by 13 per cent to $680 million. Other issues that we will discuss today include the level of housing related credit, the impact of the world economy on Australia and progress on reforms to Australia's payment system, particularly in relation to the Australian Competition Tribunal's recent decision on EFTPOS interchange fees.

Once again, on behalf of the committee, I welcome the governor and other senior officials of the Reserve Bank of Australia to this hearing. I remind you that although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. Mr Macfarlane, would you like to proceed with your opening statement before we proceed to questions?

Mr Macfarlane—Thank you. I will start, again, by saying what a pleasure it is to be here in front of the committee for the 14th time as governor. As usual, I will start by reviewing the forecasts I gave to the committee six months ago in Brisbane, then provide you with an update. Then I will move on to talk about the risks to these forecasts in both the upward and the downward direction.

Last December we thought that GDP growth in the calendar year 2003 would be 3½ per cent. We now know that it came in at 3.9 per cent, with the second half of the year being a lot stronger than the first half, but with growth slipping to 3.2 per cent in the four quarters to March 2004. Those are the figures that we got two days ago. Our forecast for growth through the calendar year 2004 is now 3¾ per cent. We began to lower our forecast earlier in the year because of weaker than expected exports and retail trade and stronger imports. We then raised the forecast following the budget, but have lowered it again to take on board the March quarter national accounts.

I must say in passing that I think the markets have overreacted to the March quarter GDP figure. It only lowered our forecasts in the mechanical sense that one of the four quarters is now lower than we predicted in our earlier forecast. It did not materially change our view about the trajectory over the rest of the year; if anything, it raised it slightly. On inflation we had forecast 2¼ per cent for the CPI over calendar year 2003. It came in a little higher, at 2.4 per cent, but has since receded to two per cent in the four quarters to March 2004, which is the latest figure we have available.

For calendar year 2004, headline inflation will be heavily influenced by movements in oil prices. In order to understand the underlying processes we should look at underlying inflation. When we do this, we are still forecasting that underlying inflation will be running at about two per cent by the end of 2004. By the end of 2005, both headline and underlying measures are likely to have moved up to about 2½ per cent. So we still have over the last couple of years a shallow, saucer shaped profile for underlying inflation. But, given the recent rises in petrol prices, headline increases are likely to be higher than underlying in the near term.

This is a pretty good outlook for growth and inflation, both in absolute terms and more particularly in relation to how things might have turned out. I would like to illustrate the latter point by referring back to a framework I put before the committee a year ago when we met in Melbourne. The framework was discussed at some length by the committee, as you may remember. The framework contained four possible scenarios—remember that this was a year ago looking forward—which I will recap. In my speech a year ago, I said:

> A weakening world outlook and an abating of domestic credit and asset market pressures would provide a reasonably clear prognosis for monetary policy. In other words, if it were weak internationally, and weak domestically, that would be easy. In the other direction, so too would a combination of a clear strengthening of the world economy and continued domestic buoyancy. That would be easy. A third possible combination, and the most favourable one for Australia, would be a firming world economy and an easing in domestic pressures, resulting in more balanced growth for the Australian economy.

I have only gone through three of the pressures so far. On the fourth, I said:

> But the combination that would be most damaging to the Australian economy would be if the household sector were to continue putting itself into a more exposed position at the rate it has over the past few years while, at the same time, a further weakening of the world economy was starting to feed through to Australian activity and incomes.

If you remember, the last mention of those possible outcomes, and the most unfavourable, was a distinct possibility a year ago. Fortunately, it did not come to pass. What occurred instead in the second half of last year was the second mentioned possibility: a strengthening world economy and a continuation of domestic credit and asset market pressures centred on housing. This was the environment in which we decided to raise the cash rate twice.

What has happened so far this year, although it took some time to clearly identify it, was the third mentioned possibility: a transition to a set of conditions in line with a firming in the world economy and some easing in domestic pressures. This was the most favourable outcome and the one most likely to result in a more balanced growth for the Australian economy. I outlined this transition in a speech I gave to Macquarie University in April, and we spelled it out more fully in our quarterly statement on monetary policy, which was published last month.

The fact that conditions began to develop along these lines is also the reason why, after the two rate rises in late 2003, we have not seen the need for action on monetary policy in any of our board meetings this year. In short, we have been comfortable with developments—a lot more so than we were for most of last year. As always, there are risks to the outlook, so I will spend the rest of my presentation discussing them.

On the external side, consensus forecasts for the growth of the world economy in 2004 put it well above four per cent, with a similar figure for 2005. Certainly the bulk of the economic data that we see supports this relatively optimistic outlook. We are in the third year of an international expansion and, unless something unforeseen comes along, we should expect the expansion to last for a good few years longer. This is not the impression you would get by following press reports on financial market developments, where downside risks to the outlook always seem to be easier to identify than upside ones. The risk of a further rise in the oil price is a constant concern, and there is some substance to these apprehensions, but I will not say any more about that subject at present, as Mr Stevens has already delivered a piece a couple of days ago covering it—although members are free to ask questions about it.

A number of others in the market worry that policy tightening in China will be overdone, leading to a collapse of the Chinese economy. I have more confidence in China than that, and I welcome the news that the Chinese authorities have been taking steps to rein in the excessive growth—particularly excessive investment. More generally, I think that financial markets have had difficulty coming to grips with the fact that the long period of very low world interest rates must come to an end and that they will have to adjust to an international environment of rising world interest rates over the next few years. Overall, we think these concerns are overdone, and we are comfortable working on the assumption that the consensus forecast for a good world recovery is a reasonable one.

We should also note that the higher oil prices and higher interest rates that people worry about are a symptom of global strength, not of global weakness. Therefore, we should not also rule out the risks on the upside. It may turn out to be the case that the very low world interest rates were kept in place for too long. In this case, we could see greater inflationary pressures than we currently expect, and in this scenario I believe the main result would be a faster rise in world interest rates as markets reacted to the prospect of higher inflation and the reality of central banks acting to keep it under control.

Turning to the Australian economy, I want to start by re-emphasising that monetary policy is determined by developments in the economy as a whole, not by developments in any one component. For example, for much of 2002-03, domestic demand was increasing at an exceptionally strong pace but the external sector was subtracting from growth. Inflation at this time was also above three per cent. Even so, we did not use monetary policy to rein in the rapid growth of domestic demand, because, for the economy as a whole—because of the subtraction externally—growth was not excessive and was not threatening our inflation objective over the medium term, despite being above it in the short run.

While monetary policy is directed at the economy as a whole, it does not mean that we have to direct an equal amount of attention to each of its components. Those parts that are obviously exhibiting a serious imbalance will attract more of our attention than those parts that are relatively well behaved. This explains why we have spent so much time talking about and researching the excessively rapid growth in housing credit and, until recently, house prices. While other economic variables were more important for the overall economic outlook—for example, consumption or wage growth—their behaviour was not as clearly aberrant and therefore not in need of such intensive study.

The forecast for GDP growth that I gave you a moment ago is based on the view that domestic demand will slow from its former very rapid rate, but at the same time the subtraction from growth due to the external sector will gradually diminish. Consumption has recently slowed a bit, although it continues to be supported by strong employment growth and will benefit from tax cuts later in the year.

Business fixed investment, particularly in building and structures, will add to growth but not to the same extent as in recent years. Residential investment is expected to subtract from growth and government spending will add to it. Overall, GDP growth of 3¾ per cent would be a good outcome. At this stage we are not assuming a significant drought effect over the coming 12 months, but this remains a downward risk given the dry conditions prevailing in some parts of the country so far this year.

On the inflation front, we do not see a problem over the next 12 months. Beyond that, the picture is of necessity more difficult to quantify. Last time we met we were slightly troubled by the fact that inflation in the non-traded sector was over four per cent and that, if this continued, it might imply a medium-term outlook for inflation somewhat above three. This is still a risk, but we have taken some comfort from the fact that some of the sectors that were pushing it up—such as house building and property services—should slow as the pressure comes off the house building sector. The continued modest growth in average wages to date also gives us some confidence. To the extent that there is an upward risk to inflation in the medium term, it is more likely to come from international developments as the world recovery gathers momentum. I will conclude by saying a few words about housing credit and house prices. In our quarterly statement on monetary policy we said:

> The run-up in credit growth and the associated boom in house prices in recent years presented two implications for the economy: they tended to boost growth in the short term, but carried the risk of a damaging correction if they continued too long.

In fact, they represented the one internal imbalance that could have put at risk the continuation of the long economic expansion that has been so beneficial to the Australian community. It is not surprising, therefore, that we experienced a feeling of relief when data started to emerge this year which suggested that the worst of the excesses may have passed. First, we saw three-monthly reductions in loan approvals, starting in November 2003, which amounted to a cumulative fall of 20 per cent. Approvals are now running at about 12 billion per month instead of at 15 billion, which they were at their peak last year. It is still far too early to know whether lending is returning to a sustainable pace. Certainly 12 billion per month is still far too high, but at least some progress has been made. The prospect of a return to sustainable rates of growth of credit now seems brighter than it has for several years—and with that comes the increased likelihood that the run of good economic outcomes will continue.

More recently, we received very strong evidence that housing prices have not only slowed their rate of increase but also fallen in level terms so far this year. This has occurred in most state capital cities, including the two largest, for Australia on average and for both houses and apartments. As the fall in prices becomes widely known, it should allow potential house purchasers to take their time and not be afraid—as so many were—that they had to rush in and buy for fear of missing their last opportunity. It should also enable them to resist the blandishments of the banks, brokers and other commission agents plying them with offers of seemingly generous quantities of credit. It should also reinforce the recent tendency of investors to question the assumption about easy capital gains. As such, we expect that the housing market will continue to go through a much needed cooling-off phase for some time yet.

That is all I wish to say about the economy at this stage, but I will be happy to answer any questions you want to put to me. I am conscious that I have been talking on the economy for quite a while and have not left any time to cover the various other areas of the bank's responsibilities—such as contributing to the soundness of the financial system, ensuring the efficiency of the payments system and issuing Australia's currency—but I am sure all these can be covered during the question and answer session. Thank you very much, Mr Chairman.

CHAIR—Thank you very much, Mr Macfarlane. As always, that was a very comprehensive overview of our economic position and economic outlook. Before we move to questions, I require a member of the committee to move that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication.

Mr NAIRN—I so move.

Mr COX—I second the motion.

CHAIR—There being no objection, it is so ordered. I would like to come back to a point in your opening remarks about the national accounts. You said that, despite the figures of the March quarter, it did not materially change your view about the trajectory over the rest of the year; if anything it raised it. Would you like to expand on that statement?

Mr Macfarlane—The first point I would like to make is that any statistical series contains underlying information and accidental variations which are sometimes referred to as noise—an engineering term. Any time you get a figure there is going to be a random element in it. Our view is that in the March quarter, random elements contributed to pushing it down. We think that the underlying economy is stronger than would be indicated by that figure. In fact, I was rather disappointed in some of the reporting of that. For example, one radio network—and I will not mention the network—started their news by saying, 'The economy has shuddered to a halt in the March quarter.' That is absolutely ludicrous. Basically, I think the developments that have occurred in the March quarter are still consistent with an economy that is growing very close to its trend rate of growth. If you look at what has happened to employment, it has been extremely strong. If you look at investment intentions, the most recent ones were revised up. If you look at business confidence, it is perhaps not quite as high as it was in the second half of last year, but it is well above its long-run average. Similarly, consumer confidence is very high. I think that when we look at the totality of evidence, it is consistent with an economy that is growing somewhere probably closer to four per cent than three per cent.

When I said, 'If anything, it raises the trajectory,' I think all I was really referring to was that if you get an observation which is well below what you expect it to be, you often get it paid back next quarter, and you get something that is slightly higher than you expect it to be and vice versa—if you got an exceptionally high figure that did not seem to be consistent with your understanding of the trend, the odds are that you will get it offset next quarter. That is the only sense in which I am saying that it may have changed the trajectory in an upward direction rather than a downward direction.

CHAIR—In past hearings we have talked about interest rates moving to normal. In your statement you talk about inflation at around two per cent and maybe, by the end of next year, both headline and underlying measures will have moved up to around 2½. What do you now describe as normal?

Mr Macfarlane—I think I would have to give the same answer that I gave last time.

CHAIR—It has not changed, in other words.

Mr Macfarlane—No, normal has not changed—that is the whole point of normal. It does not change all the time; it is meant to be a relatively fixed point that you can compare yourself to. So it has not really changed and, in our view, whatever it is we are very close to it.

Mr ALBANESE—We should swap chairs.

Mr Macfarlane—At one stage, I think I said it was 5½ to six—that was with an underlying inflation rate of 2½. At another time, I thought that that was too precise and that maybe it was 5¼ to 6¼. Anyhow, it is around there. I think that is the answer I gave you last time, and it has not changed.

Mr NAIRN—In regard to the international scene, and the US in particular, how do you see the US budget and current account deficit affecting the US dollar? Do you think it is most likely that there will be a weakening of the US dollar, and if so what will that mean for commodity prices and the trade balance with Australia?

Mr Macfarlane—I think that the level of the US dollar is determined more by capital flows than by the current account. For example, if we turn the clock back a couple of years the US had a large current account and the US dollar was going up. It was going up because the rest of the world wanted to buy US assets. They wanted to invest in the US and they wanted to lend money to the US. So notwithstanding a large current account deficit, the US dollar went up. It went up year after year even though they had a large current account deficit.

We have seen the US dollar fall over the last 18 months or so, and I attribute that mainly to the fact that, with US interest rates so incredibly low, there was not a great deal of enthusiasm for lending to the US. With the US stock market having fallen—and still falling—there was not a great deal of enthusiasm around the rest of the world for buying US assets so the US dollar went down. Over the last three months, with the US economy clearly recovering in its most fundamental sense—that is, US employment rising—we have seen another reassessment and people thinking that the US is in a good sustainable recovery. They think that US interest rates are going to go up—and they are almost certainly right. A lot of US market interest rates, like bond rates, have gone up so there has been a return of interest in lending to the US and buying US assets, and the US dollar has gone up again.

So in my view the crucial element in determining the value of the US dollar is the investors' appetite for buying US dollar denominated assets—whether they be debt or equity. I think that explains the movements that we have had recently. At the moment it is really anybody's guess. The US dollar could go up or down. If we had this discussion about four or five months ago everyone would be assuming that the US dollar was going to be plunging but over the last three months we have seen the US dollar rising.

Mr NAIRN—You mentioned US interest rates and everybody predicting that the US interest rates will go up. Currently in the US, GDP is running at 6½ to seven per cent and the funds rate is down at one per cent. If you look back in history those two figures kept pretty close together, whereas between 2002 and now we have seen the US cash rate continue to fall from about two per cent to one per cent while GDP has gone from two per cent to seven per cent. That gap cannot be sustained. How quickly do you think that that gap will close, particularly over the next six to 12 months?

Mr Macfarlane—Half of the world's financial markets are preoccupied with forecasting the answer to that question. At the moment their collective wisdom says that at the very short end, the federal funds rate—the rate that the monetary policy controls—will go up by 100 basis points, or one per cent, over the remainder of this year. That still leaves a very low federal funds rate. It still leaves a two per cent federal funds rate, which seems extraordinarily low considering the growth of the economy that you are quoting. I assume you are quoting nominal growth rather than real growth.

Mr NAIRN—Yes, nominal.

Mr Macfarlane—At the longer end, of course, the market influences what rates occur. For example, 10-year bonds have gone up already. They have not waited for the Fed to act; they have gone up in anticipation of the Fed acting. The rises so far, that expectation of 100 basis points for the Fed funds rate and the rise that has occurred in the long bond rate, which is about 100 basis points, actually seem quite small when seen in the perspective of the numbers that you were quoting. One would assume that it could be higher. Certainly, if you take a horizon longer than to the end of this calendar year and look over a couple of years, you would be expecting rises much bigger than that. You would be expecting rises in the Fed funds rate of maybe 200 or 300 basis points. I do not want to forecast what the bond rates would do, but they would presumably be higher then than they are now.

Mr COX—You said in your opening statement that it may turn out to be the case that very low world interest rates were kept in place for too long a period. You said that in this case we would see greater inflationary pressures than we currently expect. How do you measure the RBA's conduct of monetary policy against that benchmark?

Mr Macfarlane—Throughout that period we were to some extent inhibited by the fact that we had this extraordinarily low world interest rate structure that we had to make our monetary policy against. We could not completely ignore the fact that around the world we had the lowest interest rates—I gave a speech on this subject recently, by the way—of, I think I said in my speech, the postwar period. I think Glenn gave a speech where he said the lowest interest rates for a century. Basically, we had one per cent in the US, zero in Japan and two per cent in the Euro area. When you average that, you get the very shortest interest rates around the world being about one per cent. We did not join in. Our view throughout that period was that a structure of interest rates as low as that would certainly not be in Australia's interests, and so we did not participate in that. If I am not mistaken, particularly in the last year, 2003, or if we want to extend it to 2002 and 2003, we are the only significant central bank that at no stage put interest rates down—everyone else did. I think that gives you some idea that throughout that period we were very conscious of the fact that it would not have been good for the Australian economy to have had interest rates anywhere near as low as those prevailing around the rest of the world.

Mr COX—You said you were constrained by the low interest rates. Were the interest rates that you were maintaining then lower than you would have otherwise thought were desirable for domestic circumstances?

Mr Macfarlane—One could make that case. One could conceivably make that case right towards the end of the second half of last year when the exchange rate started to accelerate very quickly. I think I made the point in that speech that we would have been in a very awkward position if we had come back after Christmas and realised in our February or March meeting—particularly in our February meeting—that there was a need for higher interest rates. If you remember, the exchange rate of the Australian dollar against the US dollar went up by 10 big figures basically between the beginning of November and the middle of February. I think we were conscious all the time that we had to keep an eye on that.

Mr COX—Looking forward then, Mr Stevens foreshadowed in his speech that he expected US interest rates would have to start to address the normal criteria. What sort of implications is that going to have for our monetary policy?

Mr Macfarlane—If we talk about the short term—for example, between now and the end of the year, or slightly longer, maybe six, nine or 12 months ahead—I do not think there is a close relationship. We have demonstrated that by the fact that when everyone else in the world went down in 2003 we did not; we stayed steady. In fact we went up towards the end of 2003. So I think over periods like six months or a year there is no mechanical relationship at all. However, if you were to take a view over the whole world economic expansion over three, four or five years then I think the odds are at some point during that expansion we will go through a phase where interest rates will be above normal, just as we have been through a phase where they have been below normal.

Mr COX—If the differential between Australian and US rates diminishes, what is that going to do to the exchange rate?

Mr Macfarlane—We have had periods where there has been no differential. We have had periods where we have been 400 or 500 basis points higher than the US, if you wind the clock back 10 or 15 years. The differential will essentially depend, I believe, on what the world thinks nominal GDP growth will be in Australia and the US into the medium term. If we continue to have real economic growth and we have an inflation rate of, say, 2½ per cent and the US has an inflation rate—I do not know what theirs will be—somewhat similar or perhaps a little lower, then, in the medium term, I think we would probably end up at a position where Australian bonds had slightly higher yields than US bonds. But there could be phases within that, as there were a few years ago, where our bonds and US bonds were almost the same.

The reason that Australian bond yields are so much higher than US bond yields and have been over the last two or three years has essentially just been that our growth has been faster than US growth. And, because our growth and inflation have been faster than those of the US, we have had higher interest rates. We have had interest rates which were very close to normal; the US has had interest rates which were extremely abnormal.

Ms GAMBARO—Governor, in your statement you talked about the growth in average wages to date and you said that it has given you some confidence. What would you feel, in terms of what the inflationary pressures will be, if wages do go up in the next forecast period? Also, are you concerned that the increase in wages will be a threat in the near future at any time?

Mr Macfarlane—I think I used the words 'moderate growth in wages'. We mainly look at the wage cost index, which is the series that the Statistician started to produce about six or seven years ago, and that has been, in our view, reasonably well behaved. A couple of times we have thought we could see it starting to take off, but that has not lasted too long—it has come down again. I am not saying it is growing slowly; it is growing at a rate which, in the medium term, is probably consistent with inflation of about 2½ per cent or so. Dr Edey, what is the latest? Is it 3.7?

Dr Edey—It is 3.5 on the WCI.

Mr Macfarlane—It is 3.5 over the last year. I am a quarter out of date—I think it was 3.7 before then. Obviously, if there were a surge in wages, it would have inflationary implications, but we have not seen one, and I do not regard it as a high probability that there will be a surge in wages. There were certain sectors where wages were certainly surging. There is no doubt that in the building industry wages were growing very quickly, and it is not clear that all those increases in wages were necessarily being recorded. A lot of the increases were really in rates for subcontracting, so they were not necessarily recorded. But we think that sector will slow down and the heat will go out of it. So we are reasonably confident that wages will continue to chug along at the sort of rate they have been lately.

Ms GAMBARO—In your latest statement, you talked about the construction industry, and I want to ask you about that. I think at page 49, in table 17—entitled Wage Cost Index by Industry—the December quarter 2003 figures showed 3.6, and there had been some strength in that construction industry, as you were saying. Do you have any information feeding back to you from your regional offices that there may be some upward cost pressures, in terms of wages, in other industries? Or do you have no information at this stage?

Mr Macfarlane—The other area where there has been a lot of upwards pressure on wages, with good reason, has been in the resource sector. A lot of those mines and things are running at full capacity and a lot of work is being done to increase capacity and open new mines and new infrastructure. The wages of people who work in the engineering trades have gone up quite sharply. There is really nothing that anyone can do about that; it is probably just the market working the way it should.

Mr ALBANESE—Mr Macfarlane, the recent budget saw what some would see as a fairly significant spending spree from the government of $52 billion. Can you comment on what impact that potentially has on monetary policy, in particular whether there are any implications for interest rates?

Mr Macfarlane—As I said in my introduction, we take the budget into account when we do our forecasts. When we go through the expenditure items of the forecast there are two items: budget current expenditure and budget capital expenditure, so we include the latest figures there. If there are tax cuts, as there were, or transfer payments, they are incorporated into the forecast. When they come in they boost disposable income and through that they boost consumption and that gets into the forecast that way. I have to go back and reiterate that once we try to move directly from budgets to monetary policy we are taking an almighty leap because monetary policy, as I said, is based on what is happening to the totality of the economy, not what is happening to one particular sector. So although we take the budget and fiscal policy into account, it gets into our forecast in the same way that investment, import, exports and all those factors get into the forecast. The budget would only be crucial insofar as it actually caused the aggregate forecast to become excessive and we do not think that our forecast for the economy of 3¾ per cent is excessive; we think it is a good growth rate that can be accommodated. So we do not feel that it has had an implication for monetary policy.

Mr ALBANESE—Given that you look at the totality of the economy, do you have any comment on the impact on the totality of the economy, taking a random period of the last eight years, where every three years the average extra spending from the Commonwealth government has been $32.7 billion and in the years in between it was $3.9 billion? What impact does that have on cyclical economic activity?

Mr Macfarlane—I believe that the best way to look at those things is to not just look at spending but to look at the budget in totality and to look at the figure for the underlying cash fiscal position. If you look at that over the last X number of years—I have seven of them here—you basically see a small surplus nearly every year. We had a surplus back in 1998-99 of 0.7 per cent of GDP. I could read the rest of them if you want me to. For the year just completed we have a surplus of 0.6 per cent of GDP. The answer is that over that long period fiscal policy has been remarkably neutral. If you keep coming back to a small surplus each time then in the long run you are basically neutral. But what tends to happen—I think this is what you may be alluding to—is that if growth is a bit stronger than you thought, which has happened in many of those years, then in the course of the year the budget moves into substantial surplus, which has a contractionary effect, and then the surplus gets reduced back to a smaller surplus and that action is expansionary.

But if you add the whole thing up over five or six years, you have to add all the contractions as well as the expansions, so you really are looking at what is almost a saw-tooth pattern through each year. As you move towards a bigger surplus and then there is some spending and tax cuts or something that comes along, it goes down to a smaller surplus. But over that run of years the surplus has averaged a bit less than a percentage point of GDP but it keeps coming back to that same number. As a result, when you accumulate it, there is no cumulative impact.

Mr ALBANESE—Are you saying in terms of impact that the growth might be stronger than anticipated if it happens to be in the blimp of an election year, every third year? If you can anticipate additional spending of 10 times that of a non-election year, surely that has a distortion of economic activity and, therefore, implications for the state of the economy?

Mr Macfarlane—As I say, I do not just look at spending; I look at the fiscal impact—what has happened to the underlying cash. Underlying means you do not allow it to be affected by privatisations; that is why we call it underlying. We look at the cash surplus each year and, in almost all cases, it is a small positive number. There is another way you can do it. People look at what is called the fiscal impact, which is the change in the underlying cash fiscal position from year to year. If you look at that, you get a series of numbers which are nearly always plus or minus one. I could read these into the record if you want; I have got them in front of me.

Mr COX—There are only seven numbers.

Mr Macfarlane—There are actually only six if you do changes. In 1999-2000, the impact was minus 1.4; in 2000-01, it was plus 1.2; in 2001-02, it was plus 1; and in 2002-03, it was minus 1.1. There is some dispute about how you should calculate these over the current and the next year. In one version you would have plus 0.4 and plus 0.3; in another version you would have zero and plus 1.0. But, as you can see, in terms of fiscal impacts, in all but one of those years, you have got a fiscal impact of either plus one or minus one, so in terms of overall fiscal impact this is not all that different to what we had in the previous five years.

Mr COX—The Treasury secretary, in his speech to the Australian Business Economists said:

> A figure of around one-half of a percentage point of GDP seems to us to be a reasonable estimate of the fiscal stimulus contained in the budget.

So he has a different method as well.

Mr Macfarlane—I am not sure exactly how he did his, but his might be a very sophisticated one where they fit it into an econometric model and they put a different weight on expenditure than they put on taxes and that they put on transfer payments and they probably have different lags and all the rest. So that would explain his figures.

Mr COX—I think the difference in his is the starting point that he used for measuring when the stimulus came on, whether he used MYEFO or the last budget. You have used the last budget and I think he used MYEFO.

Mr Macfarlane—He may have. I have not looked at it closely but there is an argument going on and it is an interesting argument. If, for argument's sake, we use the more expansionary estimate, which is the one per cent, that is still not all that different. For example, if you go back to 2001, there was a stimulus of 1.2 per cent of GDP and, in the following year, 2001-02, there was a stimulus of one per cent, so there were two years in a row with a stimulus of more than one percent. I do not know when the elections were then; you people will know that better than me—

Mr COX—1998 and 2001.

Mr Macfarlane—There were two years in a row when there was a stimulus of one per cent of GDP and in fact that did not have any implications for interest rates, so I do not think one year of stimulus would either.

CHAIR—Following the budget do you see an increase in productivity and labour force participation?

Mr Macfarlane—I think one can make a case that anything that reduces marginal tax rates will at the margin increase labour force participation. I think that is the point that the secretary to the Treasury was making. I am not sure whether you could pin that down to any one particular budget, however.

Dr SOUTHCOTT—Currently there are two federal parliamentary committees which are examining the proposed Australia-United States free trade agreement and making recommendations about whether Australia should ratify this agreement. We have also have a study which was commissioned by the CIE which estimated that in 10 years time the impact on the Australian economy would be 0.6 per cent of GDP, a lot of that coming from liberalisation of foreign investment rules. Does the Reserve Bank have a view on the Australia-United States free trade agreement?

Mr Macfarlane—I am sorry to disappoint you, but the answer to that is no. I find that so complex I think you would have to be a trade specialist before you could evaluate a thing like that. Every time I find myself in a discussion with people on that subject they seem to bring up so many things that I have never heard of that I really regard myself as a rank amateur in discussing trade agreements.

Dr SOUTHCOTT—Secondly, does the Reserve Bank have a view on whether liberalisation of foreign investment rules does have a positive impact on the economy?

Mr Macfarlane—I think I have to say the same thing. That is even more complex than trade liberalisation. I think what you are talking about is the movement from a country which has already got extremely liberal foreign investment arrangements as Australia has to something which is even more liberal. I would not know how to answer that. For a very advanced country like Australia, I think the movement from a restricted regime to a liberal regime would be beneficial, but I do not know about these little movements at the margin.

Dr SOUTHCOTT—Could I perhaps put it a different way. If the Australia-United States free trade agreement is ratified, is that something that the Reserve Bank will take into account in terms of future forecasts in the area of growth?

Mr Macfarlane—Even the most enthusiastic supporters of the free trade agreement do not expect that it is going to bring results within the immediate forecasting period that we would look at.

Mr NAIRN—I come back to growth and inflation forecasts. We have seen plenty of good headlines in recent weeks about predictions of petrol prices, which people out there in the street are particularly interested in. You have said that the risk of a further rise in oil prices is a constant concern and there is some substance to these apprehensions. If you actually look at petrol prices relative to CPI, isn't it really the case currently that the price of fuel is in fact about the long-term average? Is that risk overstated by some of the commentators, do you think?

Mr Macfarlane—I am not sure I know how to answer this one. My general point when I was talking was that the international price of oil has risen. There were a number of years when it was at about $20 and now it is nearly $40; some days it is over $40. It is a doubling, and that has fed through into inflation. Really all I wanted to say was that I would not be expecting that to fall in the near future. I think we should work on the assumption that it is not going to and in fact it may even go up a little more.

A lot of people therefore say, 'Oh, well. This is going to have very bad effects on economic growth around the world.' I do not think it will have very big effects. I am working my way towards answering your question. If you look at the current price of oil in real terms—in other words, deflated by the inflation that has occurred around the world—you see that the price of oil at the moment, at $40 a barrel, is nowhere near as high as it was. Its peak was after OPEC 2, when it was nearly $100 a barrel in today's prices, and it is not even as high as it was after OPEC 1, which was when it was a bit higher than $40 in today's prices. That is the point I would make: when you see it in real terms, it is not as alarming as it appears to be when you just see it in dollar terms. I have not done the equivalent calculation for the retail price of petrol in Australia in real terms but, as you say, in real terms it probably is not exceptionally high at the moment. Can anyone hazard a better guess at that?

Mr NAIRN—That is the point I was trying to make. Relevant to CPI, I have a graph that goes back to 1982, and the price of petrol between 1982 and 1987 was substantially higher than it is today when you take that into account.

Mr Macfarlane—I do not have the numbers in front of me but that sounds plausible. It is certainly true if you look at it from the world perspective, and I am sure it is true if you look at it from the perspective of the domestic pump price.

Mr COX—You say it is going to stay up. Can you give us a calculation of what that is going to do to the CPI?

Mr Macfarlane—It depends on what your starting point is. I have information here that says that, if the price of petrol at the pump goes up from, say, 90c to a bit over a dollar a litre, it adds about half a per cent to the CPI. Is that right?

Mr COX—Yes, that is about right.

CHAIR—On a related issue: in your opening remarks, you talked about China. I noticed that one of the editions of the *Economist* last month talked about China accounting for one-third of the growth in global oil consumption. It described growth in China as 'scorching' and discussed the impact that it is having. It said that the industrial output of China has increased by almost 50 per cent in the last three years, which by any measure is amazing. In your opening remarks, you said that the market worries regarding China might have been overdone and that you might have more confidence than that. Can you explain a bit further what you see is happening in China and what the impact will be for Australia.

Mr Macfarlane—I could but, particularly as you referred to China and oil, I would like to hand that one to Mr Stevens, because he has done some recent work on that. It was contained in a speech he gave a couple of days ago.

Mr Stevens—On the issue of China's increasing demand for oil, it certainly is true that they have accounted for a big part of the run-up in demand for oil in the past couple of years. The figures are as follows. Over the two years to the March quarter of this year, global demand for oil rose by four million barrels a day. One and a half million barrels of that demand came from the OECD, who are typically the big users of oil—they use 60 per cent of global supplies—but 2.1 million barrels of that extra demand, half of that, came from Asia. Of that, 1.5 million barrels of those two million barrels were for China alone. So China's demand for oil rose at double-digit rates each year over those past couple of years.

One would imagine that, like the overall pace of Chinese growth, it may not be quite that fast into the indefinite future, but it seems likely to me that China's energy demand will continue to grow pretty quickly relative to the rest of the world. That is one reason why we feel it would be perhaps unduly sanguine to assume that oil prices are going to go all the way down to the $20 levels we saw a couple of years ago.

For Australia, it seems to me that this is very positive. China is a very large economy, a trillion dollar economy, accounting for 10 per cent of our trade, up from five per cent five years ago, with greatly increasing energy demand—not just oil but natural gas as well. I would have thought that China as a long-run proposition for Australia—and for that matter for the rest of the world as well—is a very positive thing into the future. I share Ian's view that fears of a slump in China in the near term are overdone but, even if they were not, even if they did have an unexpectedly big slowdown, it seems to me that that will not change much at all the long-run picture, which is likely to be one of very strong growth and China becoming a very, very large continental size economy in the world scene. So I think it is quite a positive outlook over the long run.

Mr ALBANESE—Mr Macfarlane, I want to refer to your opening statement. You chose to end by talking about housing, which has been a topic you have spoken about before this committee and you have publicly concentrated on over the last couple of years—about the concerns of the economic impact of the overstimulation in the housing market. In the second last paragraph you give bankers, brokers and other commission agents what I would call a whack, which is justified totally, for 'plying them with offers of seemingly generous quantities of credit'. You refer particularly to the investors who have gone out there and perhaps overborrowed large amounts. Here in the CBD of Sydney and around my great electorate, there is now a massive oversupply of housing units, particularly those that have been bought by investors. It is the same in Melbourne in particular. You then went on to say that you had not had time to comment about the soundness of the financial system and the banks' contribution. How acute do you think the problem is of the overstimulation? How much of a threat does it represent to the soundness of the financial system—the potential that is there for people who essentially have borrowed and are not going to see a return on their investment? How much of a threat is that not just to the individuals but to the soundness of the system?

Mr Macfarlane—I think you are right to say that it is certainly a threat to a lot of individuals. I think there are pockets out there where the landing is going to be very hard. Not just in Australia but in other countries like the UK and the Netherlands, which are countries which have had some similar experiences to us, when you do the arithmetic no-one can come up with an answer that says that, if the present situation unwinds, it will be so bad that it is actually going to lead to the failure of significant lending institutions. That is normally what a financial crisis means. A financial crisis normally means bank failures, bank runs. No-one who has looked at it has been able to come up with that answer, and we certainly cannot come up with that answer.

I think what could well happen is, as I say, a lot of personal distress and a lot of people who just grin and bear it but their financial circumstances would have weakened and therefore their consumption would go down. I think there are a lot of people who thought they were going to get rich and have suddenly discovered that not only are they not going to get rich but they have this asset which is costing a lot of money to service and is not going up in price; rather, it is going down, and it is hard to find tenants. For people like that, their behaviour will change. They will be much less inclined to spend than they were before. I cannot see a risk of a financial crisis as conventionally defined, but as I have said in earlier speeches I think it could have a dampening effect on the consumption of significant parts of the population.

You have to remember, however, that only 30 per cent of households are actually in the process of buying a house—in other words, have a mortgage—40 per cent own them outright and 30 per cent are renters. At most, it is going to affect that 30 per cent. I think amongst that 30 per cent the average owner-occupier is not going to be affected very much. It is the investors who are principally going to be affected. We think the estimate for the proportion of households that have investment property is extraordinarily high in Australia but it is still probably about 13 per cent. That is a very high figure. It is much higher than in any other country in the world by an order of magnitude, but it is still only about 13 per cent. Amongst that group, I could easily imagine some downward revisions to their spending plans.

Mr COX—Do you attribute the moderation in house prices to the interest rate changes of last year?

Mr Macfarlane—I would be perfectly happy to take credit for it. Whilst they have contributed, I think a number of other factors were at work. Just this year the dynamics of the cycle were meaning that they were at a point where they could go down. I think constant propaganda and reminding people of just how ridiculously high the prices were, how ridiculously low the yields were and how high the vacancy rates were got a lot of coverage and sank in. I think a fortuitous event—namely, the collapse of the Henry Kaye spruiking outfit, which got a huge amount of publicity—was extremely helpful. So I think it was a number of factors.

Mr COX—In your opening statement, you said:

Certainly, the prospect of a return to sustainable rates of growth of credit seems brighter than for several years, and with it the increased likelihood that the run of good economic outcomes of the last decade will continue.

What do you see as a sustainable rate of credit growth?

Mr Macfarlane—It is probably a rate which is above the rate of growth of nominal GDP. Off the top of my head, it may well be halfway between where we are and the rate of growth of nominal GDP. Total credit growth in Australia over the last 12 months is about 14.8 per cent. I am not quite sure what the exact number for nominal GDP is. We do not normally keep that one in our head. Halfway between six or seven per cent might be something that is sustainable.

Mr COX—I am particularly concerned about the continuing rates of household credit.

Mr Macfarlane—The $12 billion a month in housing credit is not actually being pumped out there; it is approvals that are given, and some of these approvals may not be taken up. That number is still a very high number, and of course there are a lot of lenders who have a very strong invested interest in keeping that as high as they can. Banks have been profitable because they have grown their balance sheets so fast. The banks obviously want to have as fast a growth of credit as possible. The brokers are all on commission and they are desperate to do a deal for you. It is a very different world to the one of 10 or 15 years ago, when you had to beg to get credit. Now there is a very big industry out there which is utterly determined to put out as much credit as it can.

Mr COX—What are you saying to the banks about their lending policies?

Mr Macfarlane—It is not our job to do that, by the way; it is APRA's job to do that. APRA has been talking to all of them; it has been doing stress tests. I think there is evidence that last year—and this is one of the things I should have also mentioned to you, David, in answer to your previous question—some of the banks who had let their lending rules be interpreted a bit more loosely than they should have tightened up.

Mr NAIRN—With the finance approvals that you mentioned, you said they have gone from $15 billion down to $12 billion a month, which is a start, but $12 billion is still far too high. There is a break-up in that between investors and others. I have ABS figures here which show that current financing to investors is at about $5½ billion a month. Am I right in saying it is about 50-50 of that $12 billion: 50 per cent for owner-occupiers and 50 per cent for investors? The drop seems to have been a bit over $1½ billion in the investor approvals, so probably a little bit more than half. Is that the sort of fall off that you would think is right, or should there be a bigger fall off with the investor approvals as opposed to home occupier approvals?

Mr Macfarlane—I am very surprised that there has not been a bigger fall off in investor approvals. Even the real estate agents who are usually keen to talk up the property market are saying, 'The investors have vanished.' In particular, they cannot sell any new projects. If that is the case, that they cannot sell the new apartments, one would think that it would also be rather difficult to sell other apartments. So I am surprised that that has not fallen away a lot more sharply. It is not consistent with what the real estate industry tells us.

Mr GRIFFIN—You mentioned bank lending policies. Are you aware of the CBA's family equity group of products, which was released recently? It basically involves, as I understand it, getting parents to be guarantors for other members of the family in relation to loans et cetera. Do you have any concerns about that type of product and its potential for problems within the sector?

Mr Macfarlane—I do not know much about it but I am not surprised that that particular financial innovation has occurred. We are all aware of the fact that house prices have risen so much that, for a lot of the younger generation, it is just impossible to get a deposit unless they get some help from their parents. We have already got intergenerational transfers occurring amongst those families that are wealthy enough to do it. This is a classic example of where rising house prices have widened the gap between the haves and the have-nots. Those who come from families that are wealthy enough to do it are receiving some sort of transfer, which enables them to meet the deposit and then maybe obtain a loan. It is not at all surprising that there has been financial innovation that has come up with a product which more easily taps the equity in the parents' homes in order to provide something for the next generation. I could not pass judgment on it until I had actually looked at it. It may be a good thing; it may not be a good thing. I would have to look at it in detail.

CHAIR—Given the about 18 per cent compound growth of household credit, who do you believe is responsible for what I would probably describe as the overselling of this credit?

Mr Macfarlane—There are a whole lot of people and institutions that we could look at. I do not want to say that all this credit has been foisted on an unwilling public that did not want to have it. I think there are a lot of people out there who genuinely believed, and they had some good reason to believe it on the basis of past experience, that the road to increased wealth was to gear up and buy assets that would increase in price. I think there was a public awareness amongst a lot of people that that was something they wanted to do. What we have seen is this extraordinary amount of financial innovation which has adapted quickly to that and perhaps pushed it further than it would otherwise have gone. We have, compared with a decade or so ago, a very different lending market. We have banks that are keener to lend and effectively make no distinction between investment loans and owner-occupier loans as they used to. We have the growth of the broking industry—brokers who are very keen to lend something to you and it does not really matter what happens to that loan after they have lent it to you because they have their commission.

We have the growth of the low or no dock industry. These are lenders who will lend to people who cannot or will not tell them what their income is, which is an interesting concept when you think about that one hard enough. These people are prepared to pay a percentage point or more in order not to say what their income is. We had the growth of the deposit bond, which is, as far as I know, an innovation that is unique to Australia. So we have a whole industry which is geared up to providing this credit and whose income depends on it continuing at a rapid rate. That is not to mention the real estate industry, which is always more comfortable with rising house prices and will always talk up the housing market. That is not to mention, too, the property writers, who basically are cheerleaders for the real estate industry.

CHAIR—You have mentioned all these groups and earlier you mentioned the housing investment people who could be—

Mr Macfarlane—I left one out: the spruiking industry.

CHAIR—Okay, I have just added it for you. I come to this point: who do you think should be looking more closely at this? You mentioned APRA earlier because of their role now under the new arrangements. Is it a cause of some concern to see the potential for a significant number of individuals being pushed too far?

Mr Macfarlane—I think that, as always when a new development occurs, we discover that the government superstructure we have got in place has got gaps in it. One of the things that we notice is that there is no regulation at all of mortgage brokers, yet this is an industry that has grown up and is quite big now. I do not know how big it is, because no-one knows how big it is; no-one has ever counted. I guess it is no-one's job to count how many there are. The spruiking industry fell between two stools. It fell between the states, who have responsibility for real estate, and ASIC, who have responsibility for investment products and investment advice. I think we are discovering every time these new things arise that the regulatory response is always slow and gaps appear.

CHAIR—The committee will be reporting back to parliament in a couple of weeks on our hearing with the ACCC but I cannot really go any further on that report at this stage. Do you have any suggestions as to where you see this ought to be addressed?

Mr Macfarlane—We made some suggestions in our submission to the Productivity Commission. We made a number of suggestions there, including not only about that but also about the way the tax laws are interpreted. We think they have been interpreted too leniently. We think about forms of negative gearing which appear to be so contrived and so unlikely ever to make any cash flow and are still permitted. We think those should have been addressed. We think that the spruikers problem should have been addressed.

Mr GRIFFIN—How would you address the spruiking problem, for example?

Mr Macfarlane—I think the federal and state governments have got to get together and decide which one is going to do it and come to some agreement on that. As for the mortgage brokers one, I do not think we actually made a comment on the mortgage brokers, but there is always this danger of the so-called principal agent problem. The broker is an agent and it is the bank somewhere who is basically providing the finance but the agent's incentive is just to maximise their sales regardless. They do not really have long-term aims about keeping customers happy and all the rest of it, because they do not have customers or they have a customer for the one day they make the sale and then they do not have a customer after that.

Mr NAIRN—I have a question relating to investment. I refer to the New South Wales government's recent introduction of a new tax on property, particularly on investment properties. What impact is that likely to have? Maybe Mr Battellino might like to say something about the potential impact that it might have in perhaps shifting investment from one market into another financial market or interstate.

Mr Macfarlane—I do not think it has had any impact to date. It has not shown in the figures. The figures we have got have occurred before those measures came in. They have done something which we approve of, in the sense that they have made it a bit easier for owner-occupiers and a bit more difficult for investors. Whether they have gone too far in that direction I do not know; only time will tell. But to date I do not think it has had a big impact and if it has deterred investors that may be no bad thing.

Proceedings suspended from 11.19 a.m. to 11.37 a.m.

CHAIR—Mr Macfarlane, someone did point out to me that in your opening remarks you used the word 'comfortable' twice. What do we read into that?

Mr Macfarlane—That I am an unimaginative writer.

CHAIR—We might get back to the question of household credit, because I think there might be a couple more questions on that.

Mr COX—Household credit is still about 20 per cent, so it is one of the things that is obviously pulling total credit growth up. How do you see the outlook now for house prices, the wealth effect and household credit? Do you think household credit is going to moderate? Do you think there is a chance that there will be a severe adjustment, as some commentators are suggesting, and that the correction will overshoot?

Mr Macfarlane—There are about five questions in that.

CHAIR—He always likes to have more than one.

Mr Macfarlane—I am pretty confident that house prices are falling. You may be aware that there are a number of series for house prices, none of which is entirely satisfactory. In fact, the three longstanding ones—those produced by the Real Estate Institute, the Commonwealth Bank and the Housing Industry Association—and the one produced by the Bureau of Statistics all have a significant lag in the way they record the information. They basically record settlements, which usually take place two or three months after the price is decided. So they really tell you what happened a long time ago. The ABS concede this and have mentioned it in their recent release. It is June and we have just got their March quarter figures, which of course show the average increase in the March quarter over the three months in the December quarter. That is a growth rate centred on the month of January, and it covers settlements which were contracts entered into, let us say, three months earlier. So it is telling us about decisions that were probably made in October or November. When you are trying to run forward-looking pre-emptive monetary policy and your data is really telling you what happened in October or November, that is a very long lag.

We have attempted to overcome some of this lag problem by using data that is prepared for us, at our direction, by private research firms. That overcomes the lag problem but it means the sample we look at is rather small. The earlier estimates are from a small sample. Eventually the estimates will be from the full sample. When we put it altogether our reading is that the predominant result you get—even for some of the series with a lag in them, like the Commonwealth Bank series—is that prices were falling in the March quarter. That is the answer to the first part.

Your second question was: how will household sector credit—which is predominantly created for housing—behave in the future? We believe that it will slow for some of the reasons I gave in my opening report. When the public recognise that prices are going down rather than up—as they are recognising because they are reading it more and more in the papers—I think it should affect their behaviour. I think the owner-occupiers who want to buy a house for lifestyle reasons now have a lot more time to make their decision. They can look at a lot more things and they can drive a harder bargain. They can possibly wait until they have a bigger deposit. There are a whole lot of things they can do. The urgency should have gone out of it. I would have thought the prospective profitability for investors has evaporated, so I would expect them to fall away very quickly. Again, even if they determine that they want to be an investor, they can probably get a better price if they wait for a year rather than rush in now. One would expect that we have reached the phase where the demand for credit will fall. We cannot be confident that that is what will happen but that is our expectation at the moment.

Mr COX—A fair amount of that credit is not actually for purchasing real estate; it is against the value of those assets but it is used for all sorts of consumer items. Some of it might be used for small business and equally some of it might be used for overseas holidays. Have you done any work that would indicate what proportion of household credit is for those purposes that are not bricks and mortar related and how that is going to respond to the downturn in prices?

Mr Macfarlane—The first observation is that, yes, there is a certain amount of borrowing against the equity in an existing home that does not involve a purchase of a property; we are aware of that. That does not change the picture we have been painting about the growth of credit and house prices. The second point to make is that you have a good point in that we do not know precisely how the proceeds of borrowing against the equity in an existing house are being used. We are thinking of doing a survey to find that out. The first thing that would be interesting to know is how much of it is going into renovation, for example. A lot of it will go into investment in physical property through renovation. Some of it will go into consumption, as you have said, such as an overseas holiday or a car. Some of it will go into investment. Some of it, there is no doubt, is a form of quasi margin borrowing and could go into buying shares. At the moment it is not of pressing urgency, but we think there would be a good case for conducting a survey against that subset of the population, which is quite a small subset. That subset who have chosen to borrow against the equity in the house for whatever purpose cannot be more than 30 per cent—in fact, it could be more than 30 per cent; it could be 70 per cent.

Mr COX—It is 70 per cent of the population that can relatively easily borrow the equivalent of a year’s disposable income and then consume it, and the anecdotal evidence is that a lot of that is going on. I talk to a lot of mortgage brokers, because I attend a lot of small business breakfasts and things like that and you meet them. I always ask them, ‘What are people borrowing money from you for?’ I get a lot of stories that are basically about refinancing credit cards and unnecessary discretionary expenditure. The question is whether that will be highly responsive to a downturn in house prices or whether people have just got used to that level of consumption and it will be highly resistant to changes in the value of the underlying asset.

Mr Macfarlane—My first observation is to say thank you for reminding me that there is a fourth thing, which is to consolidate other debt—in other words, to replace expensive debt with cheaper debt. On the broader issue of whether there are wealth effects that have driven up consumption because people feel wealthier because their houses are going up in value, we believe that some of that has been going on. We believe that, if it became widely known that house prices are not going up and that in fact they are possibly falling, that would have some dampening effect on consumption. We have put out a research discussion paper on that subject. So we have been looking at it.

CHAIR—That question prompts another, since housing took up a sizeable portion of your opening remarks again, as it has for several of our hearings. Given the variation in the different indicators of the movements in house prices, do you feel that it is time we had a better measure of these house price movements?

Mr Macfarlane—Yes, I do. Housing is the biggest asset in the country. Certainly for the household sector it is about 60 to 70 per cent of their total wealth. It is an extremely important asset class for most people, yet the information we have on prices is hopeless compared with the information we have on share prices, bond prices, and foreign exchange rates, and even the information we have on commodity prices, export prices, import prices and consumer prices. It really is probably the weakest link in all the price data in the country so I think it is something that I would like to see resources put into.

CHAIR—By whom?

Mr Macfarlane—We have put resources into it. We spend money on getting private research commissioned. But, ultimately, people would have more confidence in it if it were done by the Australian Bureau of Statistics. A lot of the data at the moment is voluntarily supplied by real estate agents, who might put it in some months and might not put it in other months. It is hard enough to produce good data when you are trying to produce it, but if the body producing it is not much interested in it or has a commercial interest in it coming out in a particular way, it is not going to be very good data.

Ms GAMBARO—Before we get onto the housing discussion I was going to ask about the export situation. Even though world situations have strengthened, our exports are pretty low and growth has been at about two per cent. Do you have any concerns about that? What do you forecast for our export sector?

Mr Macfarlane—I have to agree that the export results have been disappointing. The main reason is that the world economy has gone through a reasonably weak phase, although it is not in a weak phase at the moment. We would be expecting a much better picture on export volumes. We have been starting to see it in the last couple of quarters; I will ask Malcolm Edey to explain a bit more about that. The other side of exports, which has been going well for us, has been export prices, particularly on the big bulk items such as iron ore, coking coal and steaming coal. Prices have been going up quite a lot, but overall I agree with you that the performance of exports has been disappointing. They have been slow to pick up. Can you add any more to that, Malcolm?

Dr Edey—Over the past few years there was a fairly lengthy period of quite weak performance of exports associated with the recession in the major industrial countries overseas. If you look back through the 1990s you would see that the normal position is that exports would have been growing by between about five and 10 per cent per year. When the global downturn hit about three years ago, we went into a period of essentially zero growth in exports. It was quite a weak outcome compared with the previous trend. Then in the early part of last year, exports were further down because of a couple of factors. One was the downturn in global tourism associated with the Iraq war and things of that nature. The other was the drought, which dampened rural exports. Those effects had their maximum impact in about the June quarter last year.

Since then, there has been a reasonable pick-up in exports. They are up by about seven per cent since then over a period of three quarters, so that is something more like the normal growth rate that you would expect. This has occurred at the same time as the major industrial economies have been turning up, so a global upswing is helping to support that. Looking forward, we think exports are now in a position where they can recover further in line with the global recovery, so we would be expecting to see something towards the upper end of the normal range of export growth going forward from here.

Ms GAMBARO—What would that be? At the moment we are at two per cent. Are you brave enough to make a forecast?

Dr Edey—That two per cent was the quarterly movement in the March quarter.

Ms GAMBARO—What sort of movement are we talking about?

Dr Edey—I would be a bit reluctant to put an exact figure on it but, as I said earlier, normally exports grow at an annual rate of between five and 10 per cent. Going forward, the growth rate is likely to be at the upper end of that range.

Ms GAMBARO—Business investment seems to have contracted. Firms are reducing the amount of money that they are spending on plant and equipment at the moment. Do you have any concerns about that?

Mr Macfarlane—You are reading a bit too much into one quarter's results there.

Ms GAMBARO—Maybe I am.

Mr Macfarlane—We think the outlook for investment is still quite good. The statistician does a survey; there is a well known survey of businesses called the Capex survey. Looking ahead, we think that investment will be reasonably good. It will not be as strong as it was in the previous couple of years where it was exceptionally strong but we still can foresee a reasonable growth on investment. What are your figures on that one, Malcolm?

Dr Edey—We have just had a year of investment growth of about 10 per cent. Even though it has been bumpy from quarter to quarter, the movement over the last year has been 10 per cent. We are looking at an expectation of about seven per cent over the year going forward.

Mr COX—Following up on your comment before the break that oil prices would increase inflation by half a per cent, are there any implications for monetary policy flowing from that?

Mr Macfarlane—To slightly rephrase your question, it will increase the price level by half a per cent. If that indeed is what occurs, there will not be an implication for inflation. If it is simply that the price level goes up by half a per cent—so during a particular phase it looks as though inflation has gone up but then inflation comes back to whatever its normal trend was—then there is not an implication for monetary policy. That would be our majority assessment of what will happen. We had the same question when the GST was introduced. We felt confident then that the GST would lead to a once-off lift in the price level but that the rate of inflation would come back to what it had previously been. That is indeed what happened. We think that a once-off lift in the oil price is a mini version of that. If it is a permanent lift, we will just have to accept that: in one particular quarter it goes up by half a per cent and that is all that happens—it stays up there and the rate of inflation still continues to average somewhere around two point something. That is our mainstream expectation. It might be wrong. If it were wrong and did start to feed into continuing inflation, then it would have an implication for monetary policy.

Mr COX—You said before the break that the price of oil might go higher.

Mr Macfarlane—Again, if it went higher, then the once-off effect would be bigger than half a per cent, but the principle would still remain. The other thing that you have to bear in mind, which I think is also widely understood, is that an increase in the price of oil has some characteristics which are rather similar to an indirect tax. If people continue to consume the same amount of oil as they did before and it costs them more then they will have less disposable income to spend on other things, which means that consumption will be lower than it would otherwise be. An increase in the price of oil is what is called a 'negative supply shock': on the one hand, it lifts the price level and on the other hand it actually reduces aggregate demand. Depending on how those two things play out, you would have to then judge the implication for monetary policy. But if they play out the way the textbook says they should play out in an economy like this one where inflationary expectations are well anchored at a very low level, there would not be an assumption that they would cause interest rates to rise.

Mr COX—Mr Stevens in his recent speech said that oil prices were relatively low by comparison with the OPEC situation and he talked at some length about an increase in demand for oil—mostly from Asia and a little bit from OECD countries. Is that increase in price due to that increase in demand or do you see the outlook either being determined by future decisions of the OPEC oil ministers or further instability in the Middle East?

Mr Stevens—There are a few things going on in the oil market at present. The geopolitical issue—uncertainty over security of supply and so on—is one factor which some people say is putting a premium into the price of oil. I think that is probably right and one does not know how long that might last. But behind all that you have had quite a strong increase in demand for oil, as I outlined earlier, because the world economy has recovered and because China in particular is growing extremely rapidly. The underlying phenomenon in my view is that it is a demand-side phenomenon that is pushing up prices. In time one assumes that the supply to match that demand will be forthcoming without prices having to go too high, but to date I think the oil market has probably been a little surprised by the strength with which demand has increased.

Mr COX—So you do not see much possibility of the OPEC ministers simply turning the tap on and easing the pressure?

Mr Stevens—They will do that, and in fact I think they voted yesterday to increase their quota by about 2½ million barrels a day by the beginning of August. That, as far as I understand it, just validates the over-quota production they are already doing right at the moment, which is quite typical: when prices are high and demand is strong, they produce over the quota anyway. There will still be some spare capacity left in OPEC, a few million barrels a day, even after they make that increase, so I am sure they will seek to help stabilise the market by increasing their supply. That is not to say that they can completely control prices. Obviously, they cannot, or the prices would not be as high as they are.

CHAIR—Can I just follow up on that point: we have talked about the impact, as you said, of higher oil prices on inflation, but what about their impact on growth, both domestically and internationally?

Mr Macfarlane—At the margin they weaken it, because people spend more of their money on higher priced oil and have less to spend on other forms of consumption. So higher oil prices do have that effect.

Mr Stevens—But do not forget that part of the reason that prices rose was that growth was strong to begin with. It is not as though you had a given amount of growth and then all of the rise in the price of oil was exogenously imposed on the system—the rise in the price of oil happened because the growth was there.

Dr SOUTHCOTT—Mr Macfarlane, in your opening statement you talked about the difference between headline inflation and underlying inflation. What is the Reserve Bank's forecast for headline inflation for the calendar year 2004?

Mr Macfarlane—I think I will have to throw that one to you, Malcolm.

Dr Edey—It is 2¼ per cent for headline inflation and two per cent for underlying inflation.

Dr SOUTHCOTT—So there is not a great difference, but what you are saying is that you will be looking, just as you did with the GST, through the price rise. The danger, I take it, is if there is a sustained increase in the price of oil which does feed through into expectations?

Dr Edey—We always have to think about whether or not these things feed through into expectations, but we have experienced in the past much bigger one-off effects on the price level which have not fed through in that way. I think the odds are that it will not happen this time, because more and more people understand that we are in a low-inflation environment. It has been around a stable average for a long time, so I think expectations now are much better anchored than they might have been a decade or more ago.

Dr SOUTHCOTT—Is it always the underlying inflation figure that you look at in terms of the monetary policy settings?

Mr Macfarlane—No. Our medium-term objective, which is that it should average somewhere between two and three per cent, is basically in terms of headline inflation. Over short periods they can deviate, so it becomes important, but over long periods there is not much deviation.

Dr SOUTHCOTT—Is it only when you have either an indirect tax or something like a fluctuation in a significant commodity like oil that you do get that deviation between headline and underlying?

Mr Macfarlane—Taxes and oil are the main ones, but also food prices can jump by a huge amount one quarter and come back by the same amount next quarter, so we take those out too in calculating underlying inflation.

Dr SOUTHCOTT—So if there is a difference between headline and underlying you make a judgment as to whether it is a one-off or whether it is likely to be sustained?

Mr Macfarlane—That is right.

CHAIR—If there is nothing more on this, we might move on to bank fees, credit cards, interchange fees and all those other things that are creating quite a lot of public interest at the moment. I thought I might kick off by saying that it is interesting to note that bank fee income, according to your survey, I think, was up 12 per cent last year and fee income from households grew by 15 per cent—and that included a 38 per cent increase in fees from credit cards. Mr Macfarlane, does this demonstrate that bank sources of revenue are being shifted from traditional areas—since the interest rate margins have been squeezed with good competition—into a new area where there may not be quite the same level of competition? If so, are consumers just gaining on one side and losing on the other—and if you are not a borrower as such you are probably actually losing rather than getting the balancing effect?

Mr Macfarlane—The first thing I want to say is that we do not object to bank fees. We thought that the movement away from a situation where banks got all their income from the interest rate margin to one where they have a narrower interest rate margin but charge a fee for service was not only an improvement but also something that had to happen. There was no way the banks could have avoided that happening, because a competitor would do it and the competitor would end up taking all the good customers. So our attitude is that we do not object in principle to bank fees. We think that user pays, if it is done properly, is an acceptable system—particularly if there is a little safety net at the bottom, which there is. That is the first thing.

The second thing is that, overall over the last five or six years or whatever it is since we have been doing this collection, fees in aggregate have tended to go up at about the same rate as the balance sheets of banks, so their fees and their assets have gone up at about the same rate. We do not subscribe to the view that they have replaced the income they lost through the narrowing of the spread by raising fees faster in a special attempt to regain that income. There are a lot of particular things we can say about bank fees, some of which we can approve of and some of which we can disapprove of, but I think at the aggregate level we just have to say that bank fees are something that the market has delivered and that in aggregate they have not risen any faster than banks' assets.

CHAIR—Let us go more into the specifics—the things that you are not quite so happy about.

Mr Macfarlane—I was expecting that members of the committee would be very quick to identify those things.

Mr GRIFFIN—I am happy to go on that, if you want to.

CHAIR—Okay. I think Mr Griffin has been waiting all day for this.

Mr GRIFFIN—What I would like you to do is something that might help the committee. Would you do a review of where you think the payment system reforms are up to. That may save a number of questions. In the context of that, and using this as a lead-in, I take your point about aggregates. I always think aggregates are quite dangerous in what detail they hide. If we want to talk about recent fee income increases, 38 per cent—according to your own figures—from credit cards is something that the aggregates show internally that would seem to me to be quite worrying. There are probably some implications of that with respect to the outcomes of the payment system reforms. You might like to refer to those as you go. But I would like you to go through what has happened, where you think things are up to in terms of the credit card interchange reforms and where you think things are up to and what might be happening with EFTPOS, ATMs and Visa debit. That will do for a start.

Ms GAMBARO—One at a time.

Mr Macfarlane—I will start with the reforms overall. I want to go back and remind people in some sense of how we got into it. We got into it because we have got an act that said we were responsible for the efficiency, competition and safety of the payment system, including the retail payment system. When we looked at the retail payment system, we identified five main channels of payment that you can use. The simplest is cash, the next is cheque and after that there is credit card, debit card—or EFTPOS, we use the terms interchangeably—and finally electronic debiting and crediting. Those are the five main channels.

When we looked at this, we discovered that the channel or stream of payments that was growing most quickly was the credit card one. Then, when we looked at the cost to the community of using each of these five channels, we discovered that the one incurred when using a credit card was the greatest. In other words, the credit card method involves the biggest transfer of income from the public to the banks per transaction of all the five different methods of making a payment. I am using the word ‘bank’ here a bit broadly: it is not entirely banks, but about 85 per cent of it is banks. What we discovered was that the one that was most expensive to the community was actually growing faster than the ones that were cheaper to the community. We thought that this was something we ought to look into, and we did so, and we published various research studies which concluded that the method by which the pricing was constructed and various prohibitions on merchant behaviour were the things that contributed to this.

So we thought that the first priority for us was to find out why this was so and whether there was something we could do to reduce the cost of this particular form of making a payment. That was a very long process. We subsequently put out a standard which effectively reduced the core costs that underlie this—a thing called the interchange fee, which built up the amount that the merchant had to pay to their bank. That was reduced not quite to a half but a long way. We have done a survey on that and found that the reduction in the interchange fee has been carried through to the merchant service fee, which means that the banks are now receiving about $430 million a year less than they formerly were in fees from the merchants for credit cards. As well as that, we abolished the restraint of trade whereby the supplier of the credit card prevented the merchant from passing on the bank fees to the customer. We did those things, and we also opened it up.

The first phase, I think, has gone pretty well, although it took a long time. We also learnt a lesson. The lesson is that whenever you bring in a reform, even if there are five groups who benefit and one who does not, the one who does not will take you to court. With credit cards, we were in favour of the reforms, the ACCC was in favour of the reforms, the consumers were in favour of the reforms and the merchants were in favour of the reforms, but the banks and the card schemes that they are members of were not in favour of the reforms, and so we had to fight a long and costly court case.

CHAIR—I think Machiavelli worked that out a couple of hundred years ago.

Mr Macfarlane—Yes, that is probably right. We won the case comprehensively on every count in the end. The next step was EFTPOS. With credit cards, the system was designed so that the cost was incurred by the merchant, who then fed it through into the general price level, so that the cardholder could be subsidised. So the cardholder, the person who was making the decision as to which payment instrument to use, actually paid nothing. There was no transaction fee on a credit card, as you know. Every other form of payment is going to cost you money. If you go to the bank and stand in a queue to get money out, it costs you money. If you get it from the ATM, it costs you money. If you write enough cheques, you get charged for cheques. With EFTPOS you get some free transactions, but after that you have to pay a transaction fee every time you use it. Similarly, there is a transaction fee on electronic banking. The only payment instrument that there was no transaction fee on was the one that was actually the expensive one for the community, and that was to encourage the cardholder—the consumer—to use the credit card rather than one of the other forms of payment which were cheaper for the community.

The next step was to look at EFTPOS and see what we thought was right or wrong with that particular stream. We discovered—this was a long time ago; we wrote our paper on this a long time ago—that in the EFTPOS system in Australia there is a fee which the issuing bank has to pay to the merchant’s bank. This fee goes in exactly the opposite direction to the fee for credit cards. It means that it is costly for the banks to issue the EFTPOS card, which is why they recoup some of the cost from the cardholder. That is why, when a cardholder who has made a lot of transactions walks into a store and pulls out their credit card, it costs them nothing to make a transaction but, if they pull out their debit card, it actually costs them money to make a transaction, even though they are only using their own money.

We asked ourselves: why is it so and is there logic behind this particular interchange fee? We came to the conclusion that there was not. There did not need to be one and in some countries overseas, particularly the ones where EFTPOS works most efficiently—Canada and the Netherlands—there is no interchange fee. You do not need one. It is totally unnecessary in our view. We talked to various people, including the banks, and they eventually agreed to try and reduce it to zero. I want to mention that there is nothing in it for the banks because half the banks receive it and half of them pay it. For the banks, it was a zero sum game. But, even though they had nothing to gain from it and they could see that the system was unnecessary and they wanted to get it down to zero, because moving it down to zero is a collective action—it was set collectively, so moving it to another level has to be a collective action—it had to go to the ACCC for approval or authorisation.

After an initial stumble, the ACCC authorised it, but there is an appeal body beyond that called the Competition Tribunal, and so, naturally, the one group who did not benefit from this rushed off to that tribunal. So once again, even though this was a reform which had been supported by the Reserve Bank, the Payments System Board, the ACCC and the consumers—and the banks were indifferent—the merchants, particularly the big merchants, would have lost some income. They were recipients of this interchange fee. They would have lost the subsidy they were getting from the fee, so they took the case to the Competition Tribunal, which came to the conclusion that the ACCC had not made a strong enough case that reducing the interchange fee to zero was in the public interest, and so they did not uphold the ACCC's judgment. That is where EFTPOS stands at the moment. I do not think I will go on to all the other matters, because I got the impression that some of the members of the board felt that that would be just too long a monologue. I will leave it for the moment at what has happened to credit cards and EFTPOS.

CHAIR—What is the Reserve Bank's view on the Competition Tribunal decision?

Mr Macfarlane—Our view has always been—and our published view has always been—that there is no case for an interchange fee, so there should either be no interchange fee or it should be zero. That has always been our case. In the Competition Tribunal hearing, we were not actually a principal in the hearing. I believe the hearing was between the merchants and the ACCC, and we were there as what is known as a friend of court and we put in a submission in which we argued that there was no case for an interchange fee.

Mr GRIFFIN—The question is: what happens now? In tennis terms the ball is in your court. Are you able to enlighten the committee as to what the next step will be, if there will be a next step?

Mr Macfarlane—The Competition Tribunal finding is a new piece of information. We will summarise that piece of information and submit it to the public again for consultation and see what their views are and whether those views have changed. We believe that the majority of participants in the payment system would be in favour of having no interchange fee, but we are not going to just go ahead and ignore the Competition Tribunal. We regard this as a new piece of information, and we will consult again with the public. If we consult again, do further analysis and feel that there is a case for designation, we may well designate, which would bring it back into our court.

Mr GRIFFIN—Can you outline the process of consultation that you are proposing?

Mr Macfarlane—We will send a letter to the participants and give them a certain amount of time to respond with their views. We will take those views into account in making our decision.

Mr GRIFFIN—You mentioned that you were a friend of court, effectively, in that action. However, as I am sure you are aware, the actual decision by the Competition Tribunal was quite critical of the bank in relation to its submissions—and also of the banks. Given that, from what you are suggesting, you are really part way through a process, you may not wish to comment on that.

Mr Macfarlane—I have to be a bit careful in what I say, because, as I mentioned at the beginning, we are now learning that everything we do ends up in court. So I have to be very careful when I speak to you that I do not inadvertently use the wrong word at some point, because a lawyer will say that that demonstrates that I was prejudiced or something or other. So I have to be very careful in what I say. On the issue of the evidence that the Competition Tribunal wanted, I think that their legal mind-set includes a concept of evidence that is very different from ours. We think some things are very persuasive—for example, the international experience. We think it is a very persuasive economic test case, but they are not persuaded by things like that.

One of the other issues is an issue that occurred also with the credit card system. It is an issue that arises where a fee is reduced—and in our view there is enough competition for the reduction to be passed through to consumers. In the credit card case, a fee on merchants was reduced and the banks said, ‘They won’t pass it through.’ They did pass it through. We know that; we have done the research. In the EFTPOS case, the fee on the issuing bank was to be reduced and, in our view, there is enough competition to mean that the fee that currently is charged to the consumer would have been reduced. Competition would have ensured that, just as it did with credit cards. But in a court of law I think that sometimes they want more than that: they want to actually have a binding commitment. They want the banks to say, ‘When we enter this new world, this is what our fee structure will be,’ and I think banks were reluctant to do that, even though in principle, in our view, there was not much doubt that the fee to the cardholder would go down. It would not necessarily go to zero, because they are actually providing a service, but it would go down quite a lot.

Ms GAMBARO—This has been a very long, exhaustive joint study of the RBA. It looks like it has been going on since 2000. A lot of people have participated in this and have been a bit burnt in the process, and I know we are going to talk about ATM interchange reforms as well, but what do you think that that has done to people’s confidence in further reforms? In terms of the RBA’s co-regulatory approaches, do you think that a number of players have lost a bit of faith in the process?

Mr Macfarlane—When you say people have been burnt—

Ms GAMBARO—I am asking about the whole process and about faith.

Mr Macfarlane—Under our legislation we are asked to help the private sector sort it out before we designate, and that has delayed things quite a lot. That is the first thing. Secondly, asking the private sector to sort things out does not mean that they can do it completely without a regulator—and they still have the ACCC to deal with. I think some participants in the payment system are saying, ‘There seem to be two different pathways for reform. One is the Reserve Bank pathway and the other one is the ACCC pathway.’

The ACCC and the Reserve Bank of Australia are in complete agreement. We are not having a competition between ourselves—far from it. If you read the last statement that Graeme Samuel put out you would see that he is not competing for work; he wants to give it to us. I think that is one of the things we will have to think seriously about when we make our decision on designation: does it make sense to have two completely separate regulatory pathways or would it be better to have it centralised under the payment system board? That is one of the decisions we will have to make. If that were to happen I think it would overcome some of the problems that you are alluding to.

Ms GAMBARO—I was just going to ask you: if you had your way, would there have been a better way of doing it? It has been such a long-winded process.

Mr Macfarlane—The legislation says that we have to consult.

Ms GAMBARO—Yes, so you had to go through the consultation stages.

Mr Macfarlane—Not only did we have to go through the consultation; we had to try to get the private sector to work it out. As I think I said, even if the private sector were to do what we want them to do to fix up some of these things, because the agreements were already collective to change the collective agreement the private sector would have to take collective action and that immediately brings it under the purview of the ACCC. The ACCC has no choice in the matter; the ACCC has to take it on board. Once something goes down the ACCC route, even if only one person disagrees with what the ACCC says they can take it through to the tribunal.

Mr NAIRN—With regard to EFTPOS, based on what you said earlier, I presume that the RBA would disagree with the tribunal's statement that said:

The proposed agreement is likely to have the effect of passing on to the general body of consumers an annual cost of $170 million, or a substantial part thereof.

You disagree with that, I presume?

Mr Macfarlane—I cannot make a comment. That is precisely the sort of thing that I have to be very cautious about commenting on. All I can say is that you have to remember that this whole thing was about getting rid of a fee.

CHAIR—That was a very comprehensive answer. Do you want to move on to credit cards?

Mr GRIFFIN—I will. The problem is that they are all interrelated. That is the point I was trying to make at the start. I will go onto credit cards now but I would like to make some points which relate overall to the area anyway. You mentioned that you believe that you could comprehensively show that the savings in relation to credit card interchange reforms have been passed on. I think you used the term 'consumers'; I would use the term 'retailers'. Can you explain that to me?

Mr Macfarlane—We have done a survey and found that the merchant service fee has gone down. We will publish that shortly. When are we going to publish it, John?

Dr Veale—Probably next month.

Mr Macfarlane—We can demonstrate that the merchant service fee has gone down. That is the bit that is easy to measure. The next big question is one that no-one can ever resolve. The question is: if a business cost has gone down—and this business cost has gone down—will that, other things being equal, lead to prices going down? We believe it does, particularly in retailing. We believe there is enough competition so that it does go down. The problem is that the orders of magnitude that we are looking at are very small. We did the arithmetic once before. I cannot remember what it is, but it is very tiny compared to a price level which is already going up by two per cent per annum because of inflation. If this takes off 0.1 or 0.2 per cent of that, you really cannot go out and measure it. But I have enough confidence that when business costs go down, the prices go down and when business costs go up, prices go up.

CHAIR—There is one point I would like to clarify for you, Mr Macfarlane. Because this hearing is the same as the proceedings of the House, anything you say cannot be entered into evidence of a tribunal or court. So if you wanted to feel a little more free to say something, I am giving you the opportunity.

Mr Macfarlane—I do not know where that number that you referred to me came from but I remind you that we are talking about the elimination of a fee. In this whole cards area, whenever there is a fee it is put there so that someone pays it and then it can be a subsidy to someone else. So the person who receives the subsidy and loses the subsidy gets very upset.

Mr GRIFFIN—Which leads us to the figure of credit card fees from banks having increased by 38 per cent in the last 12 months.

Mr Macfarlane—That is a different subject; we are going on to a different subject there. That is nothing to do with—

Mr GRIFFIN—It is the implications of the reforms flowing through.

Mr Macfarlane—If we want to get on to that, the problem with the credit card was that the user of the credit card, the holder, was receiving a massive subsidy from the interchange fee because the merchant was paying a large amount and some of that large amount the merchant was paying was then transferred through to the cardholder's bank, and because the cardholder's bank was making so much money from the subsidy the card provider did not have to charge the cardholder for the service they were providing to the cardholder. Indeed they were providing a service, and quite an expensive service, to the cardholder. For a start they were giving you 55 days free credit, they were giving you a card, they were giving you monthly statements—they were doing a whole lot of things, and you were getting it for nothing. Normally you do not get something for nothing; normally you have to pay for it. The only reason you were getting it for nothing was because of the subsidy that was coming across from the very high fees which the merchant was having to pay and which was feeding through into the price level.

Once that subsidy went down then the banks' capacity to subsidise you was reduced, and so they have recouped some of it by charging cardholders for annual fees, late payment fees and all sorts of things but not a transaction fee. Ideally we would like to see a transaction fee but they have not done that, because the whole logic of this thing is to keep the transaction fee for the cardholder at zero. But they have recouped some—maybe all; I do not know the figures—of the income they lost from merchants by charging cardholders but not charging them per transaction; they are charging them an annual fee or a late payment fee.

Mr GRIFFIN—On that particular point, you do not see it as the Reserve Bank's role to actually monitor that aspect of the reform process, do you?

Mr Macfarlane—No, we don't, because we believe that the cardholder should be paying for what the cardholder is getting to a much greater extent than has been the case.

Mr GRIFFIN—Surely you would agree that, if you are looking at the overall implementation of the reforms, some measuring of that by some agency is necessary to establish what the real impact of the reform actually is.

Mr Macfarlane—It is all public. You can find out what each bank charges its Visa Card holder or Master Card holder per year. That stuff is in the public.

Mr GRIFFIN—It is, but, given your fondness for aggregates, the fact of the matter is that you can calculate what an individual bank may do but, in order to be able to actually aggregate and develop up a clear view of what the impact of the reform has been, you need to have that sort of figure work done. I accept it is not necessarily your job to do it, but I have got to say to you that I do not accept the position that it is not part of the reform process in terms of its actual result. It ought to be evaluated and transparently shown publicly not only in terms of the result for individuals but also in terms of the total result for the system.

Mr Macfarlane—I think we could do that. I am not saying we are opposed to doing that; we could do that. In fact, I would not be surprised if Dr Veale could roughly put his finger on some of that. All I want to say is that the general principle of reducing the cost to the entity that has got no say in what payments mechanism is used, that is the merchant, and putting some of the cost back onto the decision maker, which is the cardholder, is part of the reform process.

Mr GRIFFIN—I accept that, but my question is again that we were told publicly—the Treasurer said publicly—that there are estimated savings of over $400 million for consumers as a result of these reforms. The point that we have been making for quite some time now is that that may be the result when you look at it at the level of interchange fee, but in terms of the implications for actual consumers that is not the case because of the changes from the banks.

CHAIR—When you say ‘we’, it is not the committee.

Mr GRIFFIN—No, members of the Labor Party have been saying that. The Treasurer has said $400 million in savings and has refused to prove it.

Mr Macfarlane—I think it is the use of the word ‘consumer’ which is the problem here. By ‘consumer’, you are talking about the cardholder. I think what we have to think of are the banks’ customers in totality. Banks have customers other than cardholders and depositors; they also have their business customers. What we think of from our perspective is the provider of the payments mechanism, which is predominantly banks, and their customers. Some of their customers will be cardholders and some of their customers will be merchants. I think we should think of the reforms in terms of the banks’ customers winning rather than just one subset of the banks’ customers which is the cardholder.

Dr Veale—I can put a couple of numbers around that if that would be helpful. The governor mentioned a few moments ago that we estimate the fall in merchant revenue—merchant service fees that go from merchants to the banks—at about $430 million. The paper that the bank published in May on bank fees shows that the increase in credit card fees paid by households has risen from $438 million to $604 million. You have to net those two off. In terms of your calculation, you have the reduced income to the banks of $430 million and an increased income of nearly $150 million.

Mr Macfarlane—So customers of the banks, if we include both cardholders and merchants, are ahead.

Mr GRIFFIN—I think the banks were cranking up fees prior to that 12-month period in anticipation of the reforms.

Mr Macfarlane—Yes, that is true.

Mr GRIFFIN—On from that, the point I wanted to make in linking it to the EFTPOS fee issue and the ACT decision is that a key part of the what the ACT said concerned that question of proving benefit to consumers. I do not want you to necessarily comment on this if you do not feel that you can. I just draw your attention to that in the context of where you are going with EFTPOS and the problems that have been shown in terms of the credit card reforms that I have just been articulating. I also want to link that to the question of ATM fee reform. Where are you up to with that in respect of the process with the industry steering group?

Mr Macfarlane—Let me say just one thing about EFTPOS. I do not think there is the slightest doubt—since you are using the word ‘consumer’, that is, the cardholder—that the cardholder will benefit from the EFTPOS reform. If it works exactly the same way as the credit card reform, the cardholder will get a big benefit and the merchant will not. The merchant will find the subsidy has been reduced, so the merchants’ fees will go up somewhat and the cardholders’ will go down. On EFTPOS, instead of looking at the banks’ customers in totality and simply looking at the cardholder, I do not think there is any doubt that the cardholder or the consumer is going to benefit. Even if the banks get some of it back from the merchants, once again, we are perfectly happy with that. We think that is the way that particular form of payment should go. Could you tell me what your question was again on ATMs?

Mr GRIFFIN—Where is it up to? I know there was a proposal at the industry steering group. I know that we had John before another committee some time ago talking about that proposal, and I am wondering where that is up to now.

Mr Macfarlane—My understanding is that that steering group, which consists of the banks, building societies and another important group who are the people who provide ATMs, who are not a financial institution who entered this industry, are proposing to get rid of the interchange fee—again, getting rid of the hidden fee. They are proposing to replace it with an upfront fee, which you will see when you go to use an ATM. If it is your own bank’s ATM, maybe you will get it for nothing. But if you go to another ATM, which increasingly you will, there will be a fee up there and you will know how much it is going to cost you. At the moment, a lot of people have no idea how much it is going to cost them, because they only find out from their bank statement when it comes a month later.

CHAIR—I detect a certain sense of frustration at the pace of reform here. Is there some way that you feel it can be accelerated, or is there something missing in the regulation system that is needed to push this a bit faster?

Mr Macfarlane—I think we have it in our power to push it faster. I think we had to do it the way we did. We had to try to get the private sector to sort it out themselves. Therefore, we had to run the risk that it would go down through the ACCC and into the Competition Tribunal. We had to let that happen, and we had to look at the results and then be in a position to re-evaluate whether or not that was the best way of doing it. So that is part of the reason for the slowness of it. The other thing is the court case, which tied up all our senior people. For three to six months they were doing nothing else but preparing for that case. It was a mammoth case. Our legal costs alone were $6 million, not to mention all the other costs that we incurred. The capacity to slow things down using the court system surprised us.

Ms GAMBARO—Dr Veale, last year you presented before a Senate corporations and financial services inquiry, and you spoke about the United Kingdom’s experience with ATMs. I think they are controlled by a central organisation called Link. Can you just expand on what has happened over there in terms of ATM fees and how the public pay for that? What trends have you seen? You spoke a bit about how it was done centrally through an organisation called Link, and the ATM owner could either charge directly or they could receive an interchange fee.

Dr Veale—In the UK the ATM industry is in two parts. About 40 per cent of ATMs are owned by so-called independent deployers and the remainder are owned by the banks. In the UK, banks have adopted a knock for knock approach towards their customers. The major banks agreed not to charge any foreign customer a fee for using an ATM—that is the decision that they have made. The people who are not members of the group—that is, the independent deployers who have a single industry of providing an ATM; they are not deposit takers or banks generally—charge a fee for their ATMs, and if people want to use them then that is fine.

Ms GAMBARO—Do you think that in this whole ATM debate—and I know Mr Griffin is always talking in the House about foreign ATMs—the emphasis has been too much on the foreign fee rather than the customers own ATM fees?

Mr Macfarlane—I do not. I wish there was no distinction. I have said to people that foreign fees are too high. They say: ‘You do not have to use them. Just use your own bank’s ATM.’ But that can be an extremely inefficient use of your time. If you are in a shopping centre and your bank has not got an ATM there, what are you supposed to do? Do you get in your car and drive to another shopping centre or go searching the streets to try to find an ATM which is your bank’s? I think you have to assume that the average person will use whatever is the most convenient ATM, and that means that most of the time it will not be the ATM provided by their bank.

Ms GAMBARO—I can vouch for that.

Mr NAIRN—In that sense, do you see a risk with the reform that regions of the country could end up paying more?

Mr Macfarlane—I do not, although I know that this is something that concerns a lot of people. For example, to the best of my knowledge, at the moment banks do not charge a different fee for any of the services they provide to rural customers compared to city customers. Whatever the fee is for a withdrawal or a cheque, it is the same fee wherever you are. I would expect that that would continue if banks were free to charge whatever they wanted on their ATMs. I would expect that they would be mad not to—the reaction would be so overwhelming. I do not think they would want to anyhow. I think they would continue with their current practice of charging the same amount, wherever you came from.

Mr GRIFFIN—I note the banks’ fondness of overseas experience. Would you care to explain to us what the experience is in the UK and the US on this issue?

Mr Macfarlane—I think the non-bank provider will charge what they can charge. And I do not think that is a particularly bad thing. At the moment there are a lot of locations where no-one would put an ATM because the volume is too low. It may well be that, in those locations that currently do not have an ATM, a non-bank provider might put an ATM in there at a higher fee than in a popular area.

Mr GRIFFIN—What percentage of ATMs are not from the banks now?

Mr Macfarlane—Hang on. If that happens, I do not think that is a bad thing. All it is doing is providing someone with a choice that they do not currently have. At the moment, they have not gone an ATM. If someone puts an ATM in that has got a slightly higher fee than one in Pitt Street, you do not have to use it. But you have actually been given a facility which you have the choice to use or not use as you may wish. At the moment you have not got anything.

Mr NAIRN—So you would drive 50 kilometres and spend the money on the petrol driving to the next town.

Mr Macfarlane—I do not think that would necessarily be a bad thing. It would be a legitimate concern if people thought that the main providers of ATMs, which are banks, were going to charge differential prices between sparsely populated areas and heavily populated areas. I think that is a legitimate concern. But I do not think that will happen.

Mr GRIFFIN—What percentage of ATMs are currently run by third-party providers?

Dr Veale—About 40 per cent.

Mr GRIFFIN—What you are outlining is a process whereby that is likely to grow in the years to come. That also seems to be the overseas experience. Third-party providers tend to take over networks, even.

Dr Veale—Certainly it has grown in Australia in recent years. If you go back five or six years, there were no third-party providers. They have gone into niches and into areas where banks did not previously provide ATMs, and they have provided extra convenience.

Mr GRIFFIN—And the experience overseas is that they have also taken over some banks' ATM networks.

Dr Veale—In some cases.

Mr GRIFFIN—So we are not quite sure where the market is in the future, other than the fact that it is likely to grow.

Dr Veale—Overseas experience says that people like the convenience of ATMs.

Mr Macfarlane—The other thing is that a lot of these newer third-party providers are providing small machines. They are providing something that was not there before—in a shop, a museum or an art gallery. You go in there and find a little thing which I am told it costs about $5,000 to provide, whereas the bigger ones that you see in the bank branches cost about $50,000.

It seems to me that this is the market working. These new, cheaper products are going to areas where previously people did not have the opportunity to use them.

Mr GRIFFIN—Experience overseas is that they sometimes charge as much as $5 plus per transaction.

Mr Macfarlane—I do not know where that figure came from. I have not seen that one.

Mr GRIFFIN—I will send you some stuff.

Mr COX—I have two governance issues I want to raise with you. The first one relates to the role of the bank. Before the break we were discussing the fact that some of the banks' lending policies were probably a little loose. You said that it was really not your job to talk to them about that and that it was in fact APRA's job. If it is an issue that is of major concern to the RBA—and it is an issue on which I think it is fair to say that monetary policy has turned in the last 12 months—isn't there a role for you in talking to the banks about their lending policies?

Mr Macfarlane—When I said 'a little loose', that was probably a rather loose usage. What happened last year was that banks had a particular set of lending criteria, which were being properly adhered to by their staff. They looked at the state of that market, they looked at how much speculation there was in it, they reassessed the amount of risk they wanted to take and they basically went back and slightly toughened up the criteria that they were expecting their staff to follow.

I think that is probably a better way of describing what happened. That is essentially a decision for them to make. One of the things they could easily do is adjust the maximum loan to valuation ratio; that is the sort of commercial decision they would take. My understanding is that in some cases they brought that down and in some cases, where they previously had not insisted on a valuation, they were insisting on valuations. So they were essentially commercial decisions and, in the spirit of the deregulated financial system we run, I do not think we could really go back and intrude into those decisions.

Mr COX—I am not suggesting that you tell them what to do but don't you think there is a role for you to talk to the bank CEOs and suggest to them that they ought to have a look at it and, if they do not, certain consequences might inevitably flow?

Mr Macfarlane—I have informally spoken to several bank CEOs and given them my opinion but we do not have the powers now that we used to have to call in the CEOs and have a meeting to tell them our views. But I have given my informal opinion to a couple of them.

Mr COX—You could depute that to the Treasurer, who probably does have some authority over them since he issues their banking licences.

Mr Macfarlane—I cannot depute things to the Treasurer, I am afraid. He is not my deputy.

Mr COX—The second issue relates to an article that appeared in the *Sydney Morning Herald* last week about the activities of RBA members advising other organisations. Has the bank got a general policy for dealing with those conflicts?

Mr Macfarlane—Yes, we do have some policies. The article you refer to was not so much about advising but receiving an income and share options for involvement in what I regarded as a form of financial intermediary. In my view there would be conflict of interest in that case, so that particular activity did not go ahead. The Reserve Bank always had a prohibition on board members being directors or employees of banks. It was then widened to being a prohibition on being employees or directors of ADIs—that means all deposit-taking institutions. But in my view that is not even wide enough. I think it should be any supplier of finance. If you are an employee or a director of a supplier of finance, which means some form of financial intermediary, I think there is conflict between that and also sitting on the Reserve Bank board, where we spend so much of our time trying to limit the amount of finance that is going out. That was the basis of that decision.

CHAIR—To get onto another issue, in the financial stability review, under the question of liquidity risk, you talk about the fact that retail deposits have been falling quite significantly until recently to about 25 per cent of funding, while foreign wholesale liabilities with banks now account for 26 per cent. In other words, the foreign wholesale liabilities exceed retail deposits, notwithstanding retail deposits have picked up a little bit recently. Do you have any comment on that? Do you see that as a source of concern for the stability of banks in the fact that they are borrowing from overseas?

Mr Macfarlane—Not really. People have the idea that the typical commercial bank is something whose liabilities are the public holding deposits and then they use this to lend either to businesses or to households. They have the idea that an investment bank is exactly the opposite and that its liabilities are entirely large-scale wholesale funds that it raises in the money markets. In fact, the truth of the matter is that most commercial banks are sort of halfway between the two. They have some of their funds coming from the household sector and some of their funds coming from the professional markets. That has tended to be what has happened in Australia, particularly as the household sector have found other forms for keeping their savings in. The household sector is now more inclined to buy managed funds, shares and things like that rather than just building up big amounts of bank deposits. As that source of liabilities has gone down, banks have moved into the wholesale market and raised their funds that way—in fact, they raise it in whichever part of the wholesale market is the cheapest place to raise funds.

Over recent years, because there has been such a strong demand offshore for businesses, banks and other lenders to hold Australian dollar denominated assets, they have been able to either directly or, usually, indirectly take advantage of that by raising funds, for example, in US dollars and swapping them to Australian dollars. That has become a standard way of banks funding themselves. The crucial thing there is that the bank is not taking a foreign currency risk. The bank is either raising it in Australian dollars, or it is effectively hedging it by swapping it into Australian dollars. Banks are making these decisions every day and they are basically making the decision on what is the cheapest way of raising their funds.

Mr GRIFFIN—In relation to credit cards and surcharging, have you got any evidence as to what degree of surcharging is occurring, and would you care to comment on the question of surcharging in areas where there is no cash alternative—for example, Telstra and Qantas?

Mr Macfarlane—First of all, I will be pedantic and say I do not like the word ‘surcharging’. It is an American term. A surcharge means an additional charge on top of the charge, and since there is no transaction charge for using a credit card—

Mr GRIFFIN—I think I got it from an RBA document, actually.

Mr Macfarlane—Yes, I know; we plead guilty too. Really, we should use the term ‘passing through the bank’s fees’. That is what we should use because that is what it is. For someone who is making a payment and paying nothing, a merchant could say, ‘I would like you to pay the fees that the bank is going to charge me because you use that particular payments mechanism.’ We have not done a survey. We have had a lot of stories from (a) some big industries—obviously, Qantas and Telstra—and also from a lot of very small ones. Apparently, in the retail computing industry it is widespread—always has been. A lot of clubs are saying, ‘Here is the fee.’ Just say it is a golf club, they are saying, ‘Here is the $3,000 fee. If you want to pay with a credit card you are going to have to pay two per cent more,’ because that is what they were going to lose if you paid with a credit card. So we can see that coming through. It is not on a widespread scale, but it is coming through.

Mr GRIFFIN—What if it is not a question of you wanting to pay with a credit card but that you do not have a choice—for example, like with Telstra?

Mr Macfarlane—You have got a choice. You can write a cheque for Telstra, can’t you? You can use direct debiting. There are a range of ways you can pay.

Mr GRIFFIN—Qantas is harder.

Mr Macfarlane—Qantas might be a bit harder, yes.

Mr GRIFFIN—The other question I have is on the issue of American Express and where they are up to. There seems to be some evidence coming through—just anecdotally, anyway—of banks restructuring some of their products to take into account the advantages of avoiding the reforms through Amex—at least, it is alleged to be the case. What is your view on that and the question of what might be done about it?

Mr Macfarlane—That is an interesting one, because, as you know, the reforms apply to four-party schemes and not to three-party schemes, and now a couple of banks have decided to go into deals with Amex, which means they have turned themselves into a four-party scheme. There is a cardholder, a merchant, a bank and a card—so they have turned themselves into a four-party scheme. We are looking into that to see whether that is some sort of regulatory arbitrage that could be covered by the rules we have for four-party schemes, but we have not made a decision on that as yet.

Mr NAIRN—Also on credit card reform, David Murray criticised the reforms, which you would expect because they challenged them in the first place. You said you were going to publish the surveys next month—is that right?

Mr Macfarlane—Yes.

Mr NAIRN—You have probably seen the criticisms from David Murray. He said that they have not cut fees and there has not been an advantage over credit card issuers; retailers are not passing on the amount; and the reforms have not improved transparency. Most of the lost fees have been recouped by the banks via large increases in card fees or by diluting the value of reward points. Will what you are going to publish next month address some of those criticisms?

Mr Macfarlane—Some of those things he listed there are the successes of the scheme.

Mr NAIRN—Not from his point of view.

Mr Macfarlane—Yes, not from his point of view. The fact that the banks have lost $430 million in interchange fee is something that I think the banks do not like very much either, so one would expect that sort of criticism.

Mr GRIFFIN—It is good to see the Commonwealth Bank actually admit to the fact that they have been clawing back large amounts of it through increased fees.

Mr Macfarlane—That is also interesting, isn't it? It is part of that statement.

CHAIR—On behalf of the committee, I thank the Governor of the Reserve Bank of Australia, Dr Edey, Dr Veale, Mr Stevens and Mr Battellino very much indeed for coming before the committee and for their frank discussions. I think a wealth of information has come out today which reinforces the value of these hearings. I would also like to thank them very much for their cooperation during the 40th Parliament because, as has been indicated, this will probably be the last hearing before an election.

Mr COX—Not necessarily.

CHAIR—It is highly probable. I thank very much everyone else, including Hansard. I hope those who have been observing have got some value out of this. I say thank you also to the media for the coverage. I thank my committee members and staff.

Resolved (on motion by **Mr Cox**, seconded by **Mr Nairn**):

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

Committee adjourned at 1.01 p.m.