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**HOUSE OF
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STANDING COMMITTEE ON ECONOMICS, FINANCE AND
PUBLIC ADMINISTRATION

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 18 February 2005

Members: Mr Baird (*Chair*), Mr Bowen, Mr Ciobo, Mr Fitzgibbon, Ms Grierson, Mr McArthur, Mr Robb, Mr Somlyay, Mr Tanner and Mr Turnbull

Members in attendance: Mr Baird, Mr Bowen, Mr Ciobo, Mr Fitzgibbon, Ms Grierson, Mr McArthur, Mr Robb, Mr Tanner and Mr Turnbull

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank of Australia annual report 2004.

WITNESSES

BATTELLINO, Mr Ric, Assistant Governor, Financial Markets, Reserve Bank of Australia 1
EDEY, Dr Malcolm Lawrence, Assistant Governor, Economics, Reserve Bank of Australia 1
LOWE, Dr Philip William, Assistant Governor, Financial System, Reserve Bank of Australia 1
MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia 1
STEVENS, Mr Glenn Robert, Deputy Governor, Reserve Bank of Australia 1

Committee met at 10.02 a.m.

BATTELLINO, Mr Ric, Assistant Governor, Financial Markets, Reserve Bank of Australia

EDEY, Dr Malcolm Lawrence, Assistant Governor, Economics, Reserve Bank of Australia

LOWE, Dr Philip William, Assistant Governor, Financial System, Reserve Bank of Australia

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

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

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration. I welcome representatives from the Reserve Bank; students and staff from Caringbah, Bossley Park, St Clair, Randwick Boys, Fairfield, Emmanuel and Waverley high schools; and members of the public and the media. It is good to see all the schools here. There will be two questions to the Governor from the schools, one from Caringbah High and one from one other school. Today's hearing is the first appearance of the Reserve Bank before the committee following the 2004 federal election. The inquiry is held under the committee's authority to inquire into and report on any annual or other reports referred to it by the House. In particular, the committee will be referring to the Reserve Bank's 2004 annual report, the Payment Systems Board 2004 annual report and the Reserve Bank's *Statement on monetary policy: February 2005*.

This hearing comes at a time when there has been no change in interest rates for 15 months. Following two rate rises in late 2003 the Reserve Bank of Australia held rates at 5.25 per cent. The committee is interested in the Governor's views on the pressure facing the Australian economy, our relative performance compared to other economies, recent movements in US interest rates and whether recent inflationary pressures will flow through to higher interest rates in Australia. Of significant interest is the comment in the RBA's *Statement on Monetary Policy: February 2005* that the likelihood of further monetary tightening being required in the months ahead has increased. The committee is keen to explore why there seems to be some inevitability about the need to raise interest rates and whether this will lead to business hedging their positions ahead of the expected rise or rises.

Other matters that the committee will be pursuing today include the slowing of growth in the world economy to around four per cent in 2005-06, the flow-on competitive effects of the overvalued Australian dollar, the ability of Australian business to address the looming capacity constraints, the preoccupation of Australians with housing and the ongoing concerns associated with consumer spending and savings. Mr Macfarlane, would you now make your opening statement before we proceed to questions.

Mr Macfarlane—It is a pleasure to be back in front of this committee after a break of about eight months, and I welcome the new members onto the committee. I think all but one are new members. As you know, we take these appearances very seriously and we appreciate the opportunity they give us to explain our position to parliament and to the public. I hope that the new committee will find the exercise as valuable as we do. Earlier this month we issued our

quarterly statement which set out pretty clearly how we see the current situation. Instead of going over all the details and the same material that is in that, I would like to review the situation more from a medium-term aspect in my opening comments.

As you know, the current economic expansion, which is in its 14th year, is the longest expansion we have had—probably ever, but certainly the longest since quarterly national account statistics were first published in 1959. We had one earlier expansion that was nearly as long. That went from 1961 to 1974 but it ended with inflation pushing up into double digits followed by a recession. The following two expansions, in the seventies and eighties, lasted less than eight years each before they came to an end.

In the current expansion, the annual growth rate has averaged 3.7 per cent, but like all expansions it has not been completely smooth. For example, the annual growth rate has been as high as 6.25 per cent and as low as 1.5 per cent. On two occasions there were actually quarterly falls in GDP. But overall the results have been very favourable. Inflation has averaged 2.5 per cent per annum and we have seen the unemployment rate fall from 10.9 per cent at the beginning down to 5.1 per cent where it currently is. The longevity of the expansion has been due in part to the fact that it has been possible to avoid obvious excesses in the economy. Relatively small changes in policy have prevented the build up of the types of excess which, in the past, required a large and determined policy response. The excesses in the past have been of three main types: the first and most common was a rise in inflation; the second was an asset price boom and bust; and the third, particularly in the fixed exchange rate era, was a balance of payments crisis.

I would now like to review the current situation in light of the risks posed by these three types of excesses. The inflation risk is the one that our inflation-targeting monetary policy regime is specifically designed to control. We feel pretty confident that the type of strong monetary policy response to rising inflation that had been necessary in the past is unlikely to be needed again as long as we are vigilant. While pressures will undoubtedly arise, they should not be as powerful or as widespread as previously. First, the inflation targeting regime means that the longer inflation has been contained and the lower our inflationary expectations, the easier it is to keep things that way. Second, there have been important changes in wage setting arrangement that have meant that pressure in labour markets does not feed as quickly as previously into wage inflation. The main changes have been the decentralisation of wage setting via enterprise bargaining and the lengthening of contracts out to two, three or sometimes four years, which of course is also due to the history now of low inflation. The third influence on inflation has been the increase in competition, both at home and from abroad. These are all the good things that are making life easier for us.

But inflationary pressures cannot be completely eliminated and can be expected to make their presence felt as the economy pushes up against capacity constraints. We think that that is something that is happening now, although it is a very piecemeal process. There is no clear, economy-wide dividing line between the situation of ample capacity and one where growth is limited by capacity constraints. For example, there has clearly been pressure on capacity in the building industry for some years, as anyone who has tried to build a home or get it renovated will attest to. Over the past year, many parts of the resources and heavy engineering sectors have also been virtually at full capacity. This has, among other things, limited our export performance. Some parts of the service sector, such as accountancy and other professional services, tell us that they are fully stretched and have difficulty obtaining labour. On the other hand, there are other

parts of the economy where things are relatively normal. Overall, we are hearing more reports of businesses finding difficulty in hiring suitable labour and having to pay more for material inputs. The most obvious signs of this are the increases now being seen in producer prices at all levels and output prices for building and construction.

There has not as yet been a big effect on consumer prices but, even so, the rise over the past year has been higher than our earlier forecasts suggested. We have not seen evidence of an acceleration in across-the-board wages in the standard statistical series, although there is plenty of evidence from surveys that businesses are finding it more difficult to attract labour and that wage pressures are beginning to rise. Of course, there is no reason why the inflationary process has to be triggered by wage acceleration. It could just as easily start with prices and then move on to wages.

The second risk I mentioned earlier was a boom and bust in asset prices. I do not think this is a serious risk at the moment, although it was not that long ago that it posed a threat. In the year 2003, we had both household borrowing and house prices growing at over 20 per cent per annum, and that was on top of several earlier years of very strong rises. If 2004 had produced another year of 20 per cent plus growth, then we would have had the makings of a serious boom and bust situation. As it was, 2004 was a very good year in this respect, as borrowing slowed and house prices retreated for most of the year. Growth in household borrowing seems to have settled for the time being at a rate of about 13 per cent per annum, and house prices may have risen a bit in the December quarter; but it is too early to know where either of these are heading.

The third risk I mentioned was the balance of payments, where the current account deficit is estimated to be about $6\frac{3}{4}$ per cent of GDP. This is a high number, but not very different to the level reached on a number of occasions over the past two decades. But it is disappointing, given that it has occurred against the background of a reasonably buoyant world economy and a strong rise in the terms of trade. Strong domestic demand pushing up imports is part of the story, but the bigger part is the failure of the volume of exports to rise sufficiently to take advantage of the strong world demand. We have recently analysed this at some length and presented our conclusions in this quarterly survey. But, while the balance of payments result is disappointing, it is not a reason for a monetary policy response.

At this point, I usually look back at the forecasts I gave the committee last time we met to see how the outlook has changed. I also make a couple of new forecasts. Economic growth last year was one of the few examples where the growth rate we now expect will be well below what we had forecast. In the middle of last year we were forecasting $3\frac{3}{4}$ per cent growth for the year through to the December quarter of 2004. Now we think that when we receive the December quarter financial accounts next month they will show a growth rate of not much more than two per cent.

How do we explain the difference? One explanation would emphasise that the national accounts are showing a picture of the economy which is considerably weaker than that shown by most other indicators. For example, employment growth has been booming throughout the 12 months that GDP has apparently been restrained. The most recent five months have been the strongest for employment. The lagging nature of the employment-GDP relationship may explain part of this, but certainly not all of it.

There is a similar discrepancy in the comparison with the very high levels of business confidence that have been reported, the high consumer confidence, the increasing business profits, the booming share market and the strong increase in government tax receipts. It would be tempting to disregard the national accounts entirely and rely instead on the other indicators of economic activity mentioned above. However, I do not intend to do so. While I think that there is definitely a tendency for the national accounts to be understating the level of economic activity at the moment, I think they are right in the sense that they show that growth has slowed somewhat from 2003 to 2004.

The next question to ask is why. This is where capacity constraints enter the picture again. Economic policy in Australia—most notably, monetary policy—has allowed domestic demand over recent years to run at a relatively fast pace. As I will point out by quoting a few numbers below, this has not been translated into an equivalent growth of output, as measured by GDP. For example, in 2002 domestic demand rose by 6.7 per cent and GDP by 3.2 per cent. In 2003, domestic demand rose by 5.8 per cent and GDP by 4.3 per cent. In the most recent 12 months we have GDP figures for—which is to the September quarter of 2004, so it is rather out of date—domestic demand grew by 4.3 per cent and GDP by three per cent. So the demand has been there.

The most obvious explanation for this discrepancy is capacity constraints, and there is one in particular which we know all about: the capacity restraint which has restricted the expansion of our export volumes—mainly our resource export volumes. It is highly likely that other capacity constraints have also begun to operate. For example, the growth of manufactured and service exports has also slowed. This is partly due to the fact that an increasing proportion of existing capacity is used to supply fast-growing domestic demand. After nearly 14 years of economic expansion, we do not have the spare capacity we once had.

Looking ahead, we have to recognise this situation. Attempting to maintain demand growth at the rates to which we are accustomed would risk a rise in inflation and would probably not result in an appreciable increase in output growth. Fortunately, demand has already started to slow somewhat and it is getting closer to the growth of output. Despite its growth probably being understated, GDP is also starting to slow a bit under the constraints imposed by capacity limitations. I think we will have to get used to seeing GDP growth rates starting with the numbers 2 or 3 rather than 3 or 4, which we became accustomed to for such a long time.

On inflation: our forecast of a year ago for underlying inflation in the four quarters to the December quarter 2004, was 1½ per cent. At our June meeting here in this building in Sydney with the committee, we had raised it to two per cent. In the event, underlying inflation came in at 2¼ per cent while the headline figure came in at 2.6 per cent. Some of the reason for the latter was oil prices, but some of it was more general, as indicated by the fact that the December quarter CPI came in above all forecasters' estimates. Overall, the inflation outcome to date is still a good result, given the pressures we are now starting to see around us.

Looking over a longer period, it seems that inflation has now reached a trough and is showing signs of turning up. At earlier stages of production, there was a noticeable pickup in prices between the first half of 2004 and the second half of 2004. That is the most recent data we have. At the preliminary level, producer prices rose from 2½ per cent in the first half of the year to six per cent in the second half. At the intermediate level, they rose from 1.6 per cent in the first

half to 5.1 per cent in the second half. At the final stage, they rose from 2.7 per cent in the first half of the year to 4.7 per cent in the second half of the year.

Looking ahead, we forecast gradual rises in underlying inflation, with it reaching 2½ per cent by the end of this year and three per cent by the end of 2006. Like all forecasts, these numbers are smoother than they will probably turn out to be in reality and they are subject to risks. Our assessment is that the risks are more likely to be on the upside, as we do not see any obvious downside sources of risk unless there is a sharp weakening in the world economy—an eventuality on which we place a very low probability at the moment.

I suppose you could conclude that this combination of weaker than expected GDP growth and higher than expected inflation is a disappointing one, but while less than ideal the figures I have quoted are still pretty good for this stage of an expansion. Our feeling, though, is that we—that is, the policy makers and the public—will have to realise that there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances and excesses that have got us into trouble in the past.

CHAIR—Thank you very much, Mr Macfarlane. Before we move on, is it the wish of the committee that the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication? There being no objection, it is so ordered. I note in particular, Governor, that in your last paragraph you said that we ‘will have to realise there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances that have got us into trouble’. To my uninformed ears that seems to suggest that we could be looking at some interest rate increases. I notice that the market seems to be convinced that that is the case. In the Bloomberg commentary, Mr Lawrie Dryden says there will be definitely two rate hikes coming—he says that with great assurance. What we as a committee are wanting to know is: is it likely the markets have it about right?

Mr Macfarlane—The board will have to take into account a lot of considerations when they meet. The picture is actually quite a complicated one. In my introductory remarks I only presented really the evidence that pertained to our medium-term position. I think the board will have to look at broader issues than that, and some narrower issues than that too. It is never a simple decision. There is always a lot of conflicting evidence. In fact, I suspect some members of the committee are probably aware that there are a number of other pieces of evidence that make it a complicated picture. There are always some pieces missing from the jigsaw puzzle. You never are in a situation where the evidence is absolutely clear and everything points in one direction and nothing points in the other direction. In fact, I think if you were to wait for such an eventuality you would probably be too late.

I have given you an account of the considerations which we think are important, most of which are already contained in this document. It is up to the board to decide on the timing. The truth is that we have for some time been saying that we are in the phase of a world and a domestic economic expansion where it was unlikely that there would not be further interest rate increases—in other words, that would be a very unusual eventuality for that not to occur. We said that in August. We said that again in November. So I think the public are aware that at this phase of a cycle it is more likely that interest rates will go up than that they will go the other way. In fact, if we look around the world we see that this is happening in a number of other countries as well.

The financial journalists and the money market economists are not interested in such general propositions. They all want to particularise it and they all want to know exactly what day and by now much. The fact is we cannot say those things with any great precision; and in fact in some cases they do not actually matter a lot, as long as you get the general movement correct and you do not find you leave the economy with a misalignment, with interest rates that are either too high or too low—that sort of mistake is what you are really trying to avoid. Whether you move one month or the next month or the one before, in the big picture, is not really of paramount importance to the economy, although it is of paramount importance to people sitting on a money market desk.

CHAIR—Some economists say that perhaps the increases should have happened in previous years rather than now when some sectors are slowing. What would your view be on that?

Mr Macfarlane—I think running monetary policy by hindsight is a very interesting way of doing it. In fact, it has to be done as a result of foresight. I do not actually agree with that proposition anyhow, but there is always a tendency for people to come along and say, ‘What I want to argue with is not what is happening now but what happened a year ago or 18 months ago.’ I do not think that is the case. I think that the movements we have made were just of the right magnitude. In fact, I am never really quite sure who the people are who say that we should have moved by a lot more, but they are a tiny minority.

CHAIR—In your statement you talk about the threats that exist and you talk about wage pressures et cetera. What do you see is the major threat? Is it the labour market? Is it the capacity shortages mentioned in your February statement as well as today? Or is it easy credit, which I think you talked about in your speech to CEDA? What do you see is the major challenge?

Mr Macfarlane—To me, the medium-term one is more interesting than following a latest monthly data on this or the latest monthly data on that. I think there is enough evidence, coming from what people tell you, what you read in the newspaper, what we do when we do our own surveys and talk to businesses, that we are now entering a phase where capacity constraints are becoming a much bigger influence on how we make monetary policy than they formerly were. In fact, when we look back we realise what a forgiving environment it was when there was a lot of excess capacity, and that it is a much tougher environment now that we are seeing clear evidence of capacity constraints. So how do these show up? Do they show up in prices or do they show up in wages? We really haven’t got any more to add than what we had in our statement there.

It is showing up in producer prices—you talk to businesses—in really basic materials like steel—which is used everywhere, not just in construction or engineering; it is used in manufacturing—and plastics, which is partly driven by oil prices because plastics are really a derivative of petroleum. So it is showing up in prices, but only at the producer price level. It is not really showing up at the consumer price level.

On wages, as I said in the introduction, there are standard measures of wages that we look at. The thing called the wage price index has only been going since 1998, so we do not have a long history of it; we do not really know how it behaves over the cycle. These things seem to have shown very little in the way of increase. Enterprise bargaining, similarly: there is a bit of an increase but it is not much. In fact, looking at those two measures, you would have to say at the

moment that their growth rate is just about right: the wage price index is about 3.5 per cent, the enterprise bargaining about 4.2 per cent. Both of those figures are utterly consistent with the maintenance of inflation somewhere around the two point something—somewhere between two and three. So, in terms of the orthodox statistics, wages are still looking good. But those statistics are sort of backward looking, and we believe they would move quite slowly because, as I said before, agreements are for much longer time periods.

You have to supplement what is available in those statistics, as I said, by talking to businesses and, in some cases, by conducting formal surveys of businesses. A number of formal surveys are conducted by various bodies, such as the National Australia Bank; that is the best-known survey. Others surveys are done by ACCI and Westpac and there is also a survey of small businesses done by Sensis. These surveys are also saying that essentially we have reached the point where business is saying that the biggest constraint on their expansion is the ability to hire suitable labour. These surveys show that constraint is now higher than it has been since the late eighties. Then, of course, we conduct our own discussions; about 100 businesses a month we would talk to and we ask the same standard set of questions. So the answer is that there is definitely pressure in the pipeline, but it has not as yet shown up in the aggregate figures—and we would hope that it does not.

CHAIR—Has the appreciation of the exchange rate, in itself, added a constraining influence on inflation within the country?

Mr Macfarlane—The exchange rate is a big subject, and maybe we will return to it later. Over a particular period of about a year or 18 months, a change in the exchange rate can often be the biggest influence on inflation and an appreciation will hold down inflation over that period. You really have to look beyond that period because at some point, once the exchange rate, for example, stops going up—even if it just remains stable—that influence then evaporates. The inflation rate you are left with is that which is generated by domestic price and cost pressures. The exchange rate is important over short horizons, but it is not that important if you are trying to see beyond those short horizons. If you are trying to see two years or three years out, you cannot assume that somehow or other the exchange rate will continually move in a particular way that will give you the result you want.

Mr BOWEN—Governor, I wanted to explore a bit further the issue of capacity constraints which have been gaining increased prominence in your quarterly statements and also in your statement this morning. From skill shortages to raw material shortages, to bottlenecks in our freight system, does the Bank have a view on what the most pressing capacity constraint would be; what is having the most impact on inflationary pressures and pressures on the current account deficit? Also, what steps should we as a nation be taking to deal with those capacity constraints?

Mr Macfarlane—That really is a huge question. The most immediate capacity constraint, the one that everyone has read about and has been reading about, is the capacity constraint on exports—on the eastern coast, not on the western coast. Let me rephrase that. Everyone was caught by surprise by how strong the increase in world demand for resources would be and how large the price rise would be. Even the most seasoned mining executive who had been through umpteen ups and downs was caught by it. They did not think it would rise that much—and the evidence for that is the huge increase in prices. It was not just Australian executives who did not

see it; it was around the world people that did not see it. It is not as though when we talk about this we are trying to lay blame—who was responsible—because even the most experienced and dedicated people failed to see how fast this was going to rise. So even on the west coast, where the companies own the mines, the railways and the ports, there is no coordination problem at all; they are at full capacity. On the east coast, there are bigger complications because you have different people who own the mines, the railways and the ports.

At the moment I think the most obvious capacity constraint we see, in one case, is a port in Queensland; in another case in New South Wales it is probably railways—and also probably mine capacity. That is the most obvious constraint there. The other one, I think, is the widespread comment from the business community when asked about the difficulty of obtaining skilled labour; in fact, some say the difficulty of getting unskilled labour as well. But this is so widespread—and it has been picking up—that I think this would be the other one if I had to put my finger on a second constraint. The third part of your question I would like not to avoid but to delay answering because it is such a big issue—that is, what can the country do if it is facing capacity constraints? That is a sort of medium-term issue. I am happy to talk about it and throw out some ideas, although I am not an authority on the subject. But it is such a big question I would like to delay answering it; otherwise I will break the train of thought.

Mr BOWEN—On a related matter, the current account deficit you refer to as ‘high and disappointing but not out of the ordinary’. I wonder whether you have a view on the current account deficit being so high while terms of trade are so strong. Are you worried about a possible downturn in terms of trade which would take an already high current account deficit and make it not only unsustainable but also disastrous?

Mr Macfarlane—One could construct a scenario of that type going out. If we fail to overcome some of our capacity constraints, with imports continuing to rise strongly because of domestic demand being very strong and export volumes continuing to be weak, at some point—I do not think it is in the immediate offing—one could imagine a situation where the world economy slows down or where all the other producers of resources greatly increase their supply, and our terms of trade could fall. That is certainly a scenario that you would have to bear in mind. I do not think it is the most likely. It is certainly not the one I would like to see. I would like to see, first of all, the capacity constraints lifted and our exports start to speed up again. I would like to see domestic demand slow a little so that our imports do not grow as fast. And I would like to see the world economy continue to grow at a fair clip, which I think it will. We have really only completed three years of world economic expansion, and normally they last a lot longer than that. I think the outlook is more promising, but the scenario that you have sketched out is one that you could not rule out.

Mr BOWEN—Last year you told the committee that it may turn out that very low interest rates could be kept in place throughout the world for too long, leading to inflationary pressures. Given the recent modest rises in inflation, could you tell us where you see world interest rates at the moment and, in your view, are your counterparts overseas proving to be too cautious?

CHAIR—Especially given Alan Greenspan’s comments last night about interest rates in the US.

Mr Macfarlane—I think we have been through a period where the world economy has conducted a rather risky experiment of having very, very low interest rates—one per cent in the US, zero per cent in Japan and two per cent in the Euro area—for a reasonable length of time, a couple of years. Now, certainly in the US, they are trying to remedy it—and that is what Alan Greenspan was talking about. They are going up every meeting, and everyone expects them to continue to do that for some time. Also, they are going up in many other countries, although not in Japan or the Euro area.

What has been the result of that period of very low interest rates? You could say one of the results is this big increase in commodity prices. I think that is as much, however, to do with a different factor, which is the extremely strong Chinese economy and the emergence of India, but I think where the period of very low interest rates has had its impact is in what is referred to as this chase for yield; it has really led to more of a financial excess at the moment than to inflation. I think inflationary pressures have tended to come from China or from the growth of not just China, the growth of these emerging economies—the Brazils, the Chinas, the Russias, the Indias. I think the area where the very low interest rates have had their effect has been this intense competition amongst banks and investors to lend money and try to get a higher rate of return, which means that they are taking more and more and more risk. I think the Americans are worried about that, and they feel that the fallout may come on the financial side rather than necessarily on inflation.

Mr ROBB—Governor, I think the market certainly expects an interest rate rise. I suspect that is largely a response to the expectations created by the Reserve Bank itself in a way, and I think it might be hard to retreat from that, and I thought that was fuelled again this morning. But I must say I have studied closely this *Statement on Monetary Policy* from February and I listened closely to your statement this morning. I thought you made a very good case for not doing anything for the time being. Apart from producer price increases, which you indicated are not at the moment appearing to feed through to consumer prices, I cannot see how jacking up interest rates will help with capacity constraints. I would really appreciate some keener sense of the factors that are driving some need for a rise.

Mr Macfarlane—There is a limited amount of detail that I can really pour out. What you are really asking is for me to go through and discuss what the board will be discussing in two weeks time. In this statement, and in my introductory statements, I gave pretty convincing support to the view that we have held for some time, a view we have held since the middle of last year, that at some point interest rates should rise. I think what you are really asking me to do is to reinforce those views with additional arguments, and there really are not additional arguments—what I have provided are the arguments. At some point in this phase where we believe inflation is heading up and where we think there are wage pressures and capacity constraints and demand is still running quickly further, interest rate increases will be needed. I cannot really get any more specific than that.

Mr ROBB—Could you give a sense of your assessment of what the impact of budget surpluses over the last few years has been on inflationary pressures? How do they relate over the last few years? What has been that relationship?

Mr Macfarlane—I usually get asked this question from the other side! The answer is always the same—not a lot, not a lot. When I go overseas and I talk to other central bank governors, and

we get on to fiscal policy, everyone just says, 'Oh, how lucky you are.' The US has a big and increasing fiscal deficit; the European area has lots of countries that do not know how to keep their budget deficit down to three per cent of GDP, which they are obliged to under the Growth and Stability Pact; even the UK fiscal policy is a big issue there because of their deficit getting larger. Japan is a special case, but it has a massive fiscal deficit. If you have a small surplus every year, as we have had in Australia, it is very hard to make a case that that is inflationary and therefore it is very hard to make a case that it has any impact at all on monetary policy.

Mr ROBB—I suppose that is why I asked the question, because we do keep hearing from others that some of the budgetary activities of the government have had an impact which is inconsistent with what you have just concluded.

Mr Macfarlane—Yes, you have pre-empted your opponents there!

Mr ROBB—Just on this issue of the current account, in the OECD's recent economic survey on Australia they state:

When assessing the Australian situation, it has to be kept in mind that, with general government finances in surplus ... Australia's current account reflects private saving and investment decisions. And with structural reform having stripped out many distortions from the economy, private sector saving and investment decisions are likely to be efficient, with capital flows reflecting informed decisions about relative investment opportunities.

Do you agree with that, and could you make some comments?

Mr Macfarlane—I agree with part of it. It is true that the current account deficit reflects private sector decisions—that part is correct. The current account is equal to the difference between investment decisions and savings decisions. In Australia they are made essentially by the private sector, although there are incentives in the system which sometimes, I believe, can distort the pattern. So, as we moved from a current account deficit of about two per cent of GDP three years ago to what we have now, of 6¾ per cent, some of that was due to a reduction in savings—about 1½ per cent was due to a reduction in savings—and three per cent was due to an increase in investment. Normally you would say that that is great—it is mainly an increase in investment. But of that three per cent of GDP increase in investment, 1.7 per cent of it was residential construction. I think the direction of credit and spending towards that particular sector, the housing sector, even though it was a private sector decision; it was individuals making those decisions—I think in the long run we may well have wished that more of that had gone into common or garden business fixed investment rather than in residential. But if you just look at investment in its totality, it is true that the current account deficit in Australia is not due to government budgetary decisions—it is due to private sector decisions.

Mr ROBB—Could I just have a supplementary question. Thank you for that explanation. Alan Greenspan recently put a view that, with the age of globalisation, there is a much greater willingness for the financial market players to reach beyond national borders and invest in foreign countries. His point was that the consequence of investment in domestic savings taking their own course is that current account balances are likely to widen as a matter of general principle. Could you comment on that?

Mr Macfarlane—Yes, he is quite correct. The postwar world has basically moved from one where there was very intense pressure brought to bear on economies by their external balance or imbalance. When we had a fixed exchange rate world in Australia, current account deficits were very small because it was very difficult to finance them. If there was an unwillingness to finance it at that fixed exchange rate, there was a balance of payments crisis and governments had to get in there and increase taxes and slash expenditure and central banks had to push up interest rates, and the external constraint was very, very binding during the so-called Bretton Woods era. What we have seen is that gradually break down. As capital has become more and more willing to take risks in other countries and in other currencies, and as financial innovation has found ways of hedging the currency risk, it is not the binding constraint.

In Australia, we have got a current account deficit of $6\frac{3}{4}$ per cent of GDP. That would have been impossible to have that in the fixed exchange rate era and would have been very difficult even in the intermediate era. In fact, in 1985 we got very close to seeing that as a crisis. People have forgotten that interest rates in 1985 went up to 18 per cent. They were higher in 1985 than they were in 1989 because the exchange rate was plunging and we were in the intermediate zone, whereas now there is so much incredibly mobile international capital and they have found so many sophisticated ways of hedging their risks that it is possible to finance current account deficits for very, very long periods. I can remember a lot of the Europeans who five years ago were saying, ‘Oh, the US current account deficit is unsustainable.’ We never said that. I cannot remember what it was then—it was $3\frac{1}{2}$ per cent of GDP; now it is $5\frac{1}{2}$ per cent of GDP. In a world of extremely mobile international capital, the external accounts are nowhere near the constraint they used to be.

Ms GRIERSON—Governor, from your February statement on monetary policy, it did appear to us that, on balance, an interest rate increase would be imminent. The response to that was some concern from analysts that there were indicators that growth is slowing, so your comments today about that lower than anticipated GDP figure of two per cent are very concerning. One would think that it compounds and adds to the concern that the slowing in growth is real. Therefore, the use of a blunt instrument, interest rates, will have a strong effect or potentially, given the indebtedness of our country, a far-reaching effect and, therefore, could have an effect that is not desired—and that is of too much slowing of that demand. Could you comment on that?

Mr Macfarlane—You are right. Obviously the board will have to weigh up all these things. There are two prominent indicators that show weakness, one of which is GDP, which I mentioned. In the three quarters of 2004 for which we have data, each time the figure has surprised people by being lower than people thought it would be, given what else was going on. Of course the other one which a lot of people have seized on recently is retail trade, which fell according to the statistics in the December quarter. We find that also completely contrary to all the other indicators we have on retail trade. Retail trade is only 40 per cent of consumption, but it is often a good indicator of what is happening with consumption, and obviously we take that into account.

The retail trade figures tell us a very different story from what the retailers are telling us and a very different story from what some of the other indicators are telling us. For example, I just took out the figures, because they were quoted in the papers this morning, on credit card spending. Retail trade figures say that, over the year to December, retail trade in nominal

terms—that is over the year and not the quarter—rose by two per cent. Credit card spending went up by 11 per cent. The cash card index, which is debit card spending, went up by seven per cent.

We have to look at every figure we receive and compare it with all the other indicators of the same thing, and we have to come to an on-balance judgment. You are never in a position where everything tells you the same thing. I think it is possible that the economy has decided to slow appreciably of its own accord. We think that is not likely. We think that demand has slowed a bit, but part of the aim was to get it to slow because demand had been growing so much faster than output. But it is possible and that is why these decisions are always very difficult to take and that is why we have to look at so many pieces of information.

Ms GRIERSON—Do you anticipate that there will be an impact on our exchange rate? If we have these underlying problems—the current account deficit as high as it is, and we have perhaps a movement to rein in demand and expansion through interest rate changes—are we going to see an exchange rate that is very strong? Are we going to see that change to hopefully assist our export performance? What are your views on what is going to be the impact on exchange rates?

Mr Macfarlane—I think the main influence on exchange rates is what the market thinks needs to be done rather than what is actually done. In other words, expectations are often as important as the actuality. You have brought up the subject of the exchange rate, so maybe I should say a few words about that. Yes, it is true that our exchange rate has risen over the last two years quite a bit. It is at about 10 per cent above its average for the period of the float. The interesting thing is, though, to what extent was it due to things that happened in Australia and to what extent was it due to something that was happening in the rest of the world?

If we concentrate at the moment on the exchange rate that most people look at, which is the exchange rate between the Australian dollar and the US dollar, what has happened is really mainly a US dollar story. The US dollar has fallen against all the floating exchange rate countries. So it has fallen against us, it has fallen against the euro, it has fallen against the pound, the Canadian dollar, the New Zealand dollar—you name it. The interesting thing is how similar the size of the fall has been against each of us. For example, the US dollar has fallen 35 per cent against the Australian dollar, but it has fallen 33 per cent against the Euro—almost exactly the same; 33 per cent against the Swedish kroner; 30 per cent against the Swiss franc; 47 per cent against the South African rand; and 41 per cent against the New Zealand dollar. The other way is to say that we have all gone up against the US dollar. The two that went up the most were obviously two commodity currencies—the rand and the New Zealand dollar—and we were the third. We are also seen as a commodity currency, so we went up. The thing that is interesting is that our rise against the US dollar was almost exactly the same as the euro area's rise against the US dollar.

I suppose what I am saying is that we did not get a very big effect on us coming from these two other factors that you would have thought would play a big role, one of which is the big rise in our terms of trade and the other one being that our interest rates are a lot higher than the interest rates in the euro area. So the combined effect of those two extra factors, which would normally be expected to push us up a lot, actually did not push us up very much. That does not mean that it is not going to happen in the future, but so far we have tended to move roughly in

line with the second biggest currency in the world, which is the euro, even though our economic characteristics are very different from the economic characteristics of the euro area.

Mr McARTHUR—You say in your opening remarks that you do not foreshadow a boom bust in asset process. I just seek your rationale for that, given that resource stocks and prices have moved up quite dramatically. You saw yesterday the BHP profit result reflecting that profitability in the resource stocks. Consumer confidence and housing prices, in the view of some, remain very buoyant. Some of us would suggest that you are at the end of the cycle of a fairly long growth period. Why would you not get into a bust situation, given that scenario?

Mr Macfarlane—Let us start with housing, which is the one where I thought there was a threat. I think the answer is that the boom part seems to have stopped and been followed by something that is reasonably flat. I would characterise it as three small falls in the first three quarters of last year and a small rise in the last quarter but prices in net terms down over the year. I do not call that a bust. A bust is when there is a much bigger fall and there is distress selling and all that sort of stuff. We certainly have not seen that. The likelihood of that happening is so much lower now, as I said, than if the boom period had continued for another year. So it is still possible that there is a much bigger shake-out to occur, but the fact that we have traversed the first year very well I think is encouraging.

On the share market, it is true we have virtually the strongest share market in the world. I was at a meeting once and someone said, ‘Australia has the strongest share market in the world’. Someone piped up and said, ‘No, the Egyptian is stronger’. That shows you how far and wide you have to go to find a stronger share market. I am not an expert on the correct valuation of the share market, but the conventional things you look at, the PE ratios and things like that, show that it is higher than average but not exceptionally or dangerously high. What that means is that most of the very strong rise in the share market has been based on the fact that company profits have been rising so strongly. So I do not see that as a risk there either.

The final point I would make is that, in the past, the bust has often been associated with very big domestic imbalances—that is, inflation rising a lot and having to be countered by very big rises in interest rates. That has often been part of the story of the move from boom to bust. That was a part of the story for us, for example, in the late eighties and early nineties. We do not envisage that. We think we have a situation where inflation will remain at a very satisfactory level. We do not think we are going to lose the situation as it was lost in the seventies and the eighties. We think that relatively small, well-timed movements mean that everything stays under control. That does not mean you cannot have a boom and a bust, I agree. For example, the Americans had a boom and a bust in the dotcom bust against a background of reasonable growth and low inflation. But there there were some extraordinary signs which you do not see here.

Mr McARTHUR—Can I just ask what would happen if the commodity prices came off their current buoyant level, shall we say, across the metals export area?

Mr Macfarlane—The first thing that would happen is that it would not be very good for our balance of payments, which we have been through. Similarly, it would not be very good for the profits of the big resource companies, and you would expect to see falls in their prices. But they are not a big enough part of the Australian stock market to really drive the sort of dangerous scenario you are alluding to.

Mr TANNER—Given that you are effectively shifting the bias from neutral to tightening, I was wondering if you could do a compare and contrast between the economic conditions and the data that prevail now and what prevailed during 2004. Given that we have slowing growth figures, the weaker retail sales data which you have queried but nonetheless cannot be totally discounted, the fact that the likelihood is that the Australian dollar will continue to strengthen, the fact that the evidence of wages inflation is negligible—that is about the best descriptor that can be used at the moment; there is some minor anecdotal stuff but there is nothing really substantial—and of course the slowing of the housing market, I am interested to compare those conditions. You seem to be placing a lot of emphasis on producer prices as a factor. I am interested to compare that as a set of circumstances where there appears to be a need to increase rates with the circumstances that prevailed during the bulk of last year. It seems to me that suddenly you have become quite a bit more cautious. I am interested to hear your response to that. Associated with that, on Mr Robb's question about fiscal policy, can we infer from your comments that the key issue there is an absolute, not a relative, and that provided the budget is in surplus a relative change, loosening or tightening, does not matter, or is it more appropriate to say, as I would suggest, that a relative change, even if the budget remains in surplus, is of some significance to monetary policy?

Mr Macfarlane—In the first part of your question you use the shorthand terminology which the Americans use, saying 'changing a bias'—maybe you did not copy it from them—that we went from neutral to bias to tighten that, that is not true. We already had a bias to tighten, in the sense that in our previous statements in August and in November the much quoted line that came from each of those things was that towards the end of our overview we said, 'People should accept that it would be unlikely for there not to be further increases in interest rates during this expansion.' So we already had that assumption that people should be looking at a world where it either stays the same or goes up. The February statement essentially said, 'That stays in place, except we think it will be sooner rather than later.' So we did not move from neutral—we were not neutral in the second half of last year.

Mr TANNER—The tightening of the tightening.

Mr Macfarlane—In the second part of your question you went through some of the weaker statistics—for example, retail trade—and you cast doubt on the survey information we get on wages and producer prices. I do not really think I can go through a blow-by-blow description arguing the point on each of those again. I think the quarterly statement and what I have said this morning are as much as I can say on that. On the third point, whether the fiscal position is inflationary or expansionary, I just prefer to use the word expansionary because only once expansionary runs up into supply constraints does expansionary then become inflationary. Your question is: if you have a constant surplus from year one to year two, is that sufficient for me to say that it is not having an expansionary impact?

Mr TANNER—No. The question is: is any change irrelevant provided that the budget still is in surplus? That seemed to be the implication of your answer to Mr Robb, which was if the surplus drops substantially it does not matter provided it is in a surplus.

Mr Macfarlane—No. The shorthand is a thing called the fiscal impact. All the textbooks show that the shorthand way of calculating the fiscal impact is the change in the budgetary position. It is the movement. So the movement from a large surplus to a small surplus would be

expansionary and, similarly, the movement from a large deficit to a small deficit would be contractionary. So at a first approximation it is the change in the position. There are a whole lot of other complications that you have to add in if I were sitting in the Treasury calculating these things, but that is the first approximation.

Mr TANNER—Could we not therefore say that is precisely what we have had over the last nine months or so and that has to be a factor in the tightening of the tightening?

Mr Macfarlane—No, I do not think that is the case. If you go through and you follow the estimates for the size of the budgetary position from when the budget first made an estimate towards the most recent one, the MYEFO, that shows a slightly bigger surplus than the one that was contained in the budget.

Mr FITZGIBBON—It is not expected.

Mr TANNER—It depends which you compare it against.

Mr Macfarlane—What I am saying is that, on our most recent estimate, despite all the election spending, the outcome for this financial year will be a slightly smaller surplus than was envisaged at budget time. Of course, that is one of the arguments that I use for why I think there is more underlying strength in the economy than the national accounts show. The taxes have been pouring in because there has been very strong employment growth, good real income growth and companies have been very profitable—and so the taxes have been pouring in.

Mr TANNER—In reference to manufacturing, you say in your February statement that strong growth in domestic demand may be the cause of the effective or relative decline of manufacturing exports. My understanding is that manufacturing output has only grown by about six per cent over the three years to about September last year. Correct me if I am wrong on that figure, but certainly there has not been any spectacular growth in manufacturing output as a whole. So I query how you reach the conclusion that stronger domestic demand for manufactured products is somehow to blame for the flattening of manufacturing exports. Associated with that, to what extent is the relative decline in non-commodity exports, basically since the turn of the century, relative to GDP? To what extent is that connected with issues of government program support like R&D, tax concessions, factor F and all those kinds of things?

Mr Macfarlane—We do not have a generally accepted industrial production index in Australia; we are one of the few countries that does not. So we do not really follow industrial production or manufacturing output in the way that others do. What series are you referring to?

Mr TANNER—I have just been given ABS data. As I say, I am not absolutely certain of that figure but, as far as I know, there is no evidence of a strengthening of manufacturing output relatively larger than the strengthening of the total economy, and therefore I am querying the suggestion that somehow domestic demand has altered the export situation. I am interested to know what the evidence is to suggest that the softening of manufacturing export performance is somehow connected to domestic demand.

Mr Macfarlane—I do not think I can answer it over the most recent period, but people who look at manufacturing exports or exports for countries usually find that, in periods of strong

domestic demand, exports are weaker than in periods of weak domestic demand. There is some substitutability for a lot of companies as to where they fill their orders, but I do not have any direct evidence over this particular three-year period.

Mr TANNER—Frankly, I find that a bit puzzling. We have had pretty strong domestic demand for quite awhile now, yet you have seen a significant turnaround in those things only in the last three or four years, and the statement is pretty clear in saying that domestic demand could be the factor. I am interested to explore that further.

Mr Macfarlane—Maybe what you are highlighting are some other capacity constraints that we are not aware of, because there has been enough demand. This is part of the thesis throughout: there has been enough demand and, where there has not been enough output, there must be some explanation other than insufficiency of demand. There may be some of these other factors that you mentioned towards the end of your question. I do not know enough about it to answer that, but there may be something in it.

Mr TURNBULL—Governor, I think the committee has almost exhausted its efforts to persuade you not to put up interest rates, so I would ask you to look forward to the risks. As you know, there has been a lot of commentary in the marketplace to suggest that a better time to increase rates would have been last year, given the various economic factors at the time. With the anticipated slowing in GDP, you said that you expected the next number to be running at two per cent. Then there is the rise in the dollar and the inverted yield curve. These are all things which would suggest that this is a less propitious time to put up rates. Assuming that you proceed with increasing rates, the big story, as you have said, in terms of foreign exchange, is obviously the long-term decline of the US dollar—and that decline, and its impact on Australia, is something over which we have no control, no influence. You have mentioned that the Australian dollar seems to have been linked to the Euro. You might comment whether you think that is just circumstantial; it is hard to see what logic there is in that link and whether it is just that everybody is moving up or down, depending on the tide of the US dollar's appreciation—or depreciation, as we have at the moment.

The point I am concerned about is: do you believe that the risks of a rate rise at the moment are greater because of, firstly, the slowing in asset prices, or the decline in asset prices, particularly housing, which you have observed? We know that there is a wealth effect on consumption—households have been consuming more and borrowing more because they feel they are wealthier, they see the value of their house increase, and they say, 'I can afford to spend more.' We saw in the United States a dramatic decline in consumption after the stock market collapse—after the tech bubble burst—and America's stock market portfolios had a dramatic hit, so people pulled in their horns.

You have said in your *Statement on Monetary Policy* that disposable income was boosted by the measures in the May 2004 budget, particularly the lump sum payments associated with the family tax benefit and income tax from 1 July. But you went on to say:

It appears that consumers have saved a larger-than-expected proportion of the proceeds of the fiscal stimulus.

So Australians were not as profligate as the central bankers may have feared, which is good. You have also gone on to make the point which I just adverted to, which is that there has been a

reduction in consumption arising from a perceived weakness in house prices. So we have a situation where a number of factors are tending to slow down demand. You are expecting the economy to slow; you have warned us against that. You have said that you would not justify an increase in rates on the basis of wages pressure, asset prices or balance of payments, so your focus is on demand. If you increase rates now, and if we also get a bumpy depreciation of the US dollar, which obviously moves in a very jerky fashion, inevitably there will be pressure on Australian households. Bearing in mind that the most indebted Australian households are couples under 40 with families—and you are more familiar with that than we are—isn't there a real risk that we might get a double whammy next year because of the rate rise slowing, and the already slowing domestic demand, and then being hit by international factors which will have a cumulative effect?

Mr Macfarlane—Can I start by saying that this is the first time I have ever been before this committee where several members have said, look, the thing that is wrong with you is you should have put rates up more last year. Now I do not know who you have been talking to but this is a very new idea to me and I am still coming to terms with that, I am feeling really guilty.

Mr FITZGIBBON—We mean just before the election.

Mr TURNBULL—Governor, I think the slowing in demand has demonstrated your great wisdom and restraint in not putting up rates last year and all I am suggesting, with great respect, is that perhaps the wisdom that guided you in that direction last year should continue into this one.

Mr Macfarlane—The story about declining asset prices: what we have seen recently is more a shift. We have absolutely booming share prices. In fact one of the members wondered whether we were not in the first phase of a boom and bust. So we have booming share prices and we have a correction to house prices—they have gone down a small amount. Is this a sign of financial stringency and distress or people tightening their belts?

I am very pleased that house prices fell. As you know, I spent a lot of time trying to talk them down and I am pleased that householders are no longer borrowing at the extraordinary rate that they were borrowing in 2003 but they are still borrowing at a pretty fast clip; 13 per cent, that is the lowest we can get, that is if we can take the last six months and annualise it. If we look over the last year, it is about 15 per cent. So they are borrowing at a rate that still means that their debt to income ratio is rising, that their debt servicing ratio is rising. To me, that is not a sign of people who are suffering from some negative wealth effect. In fact, the owner-occupier element have not changed their borrowing very much at all. Most of the slow down—and this again is a very good thing—has been in the investor housing sector. So what we have seen is a very healthy movement back towards something more normal, in my view, rather than the sign of some weakness in the household sector. I think it is a good sign, that things have moved back towards more normal. Now I am not sure whether I have answered all the questions. There was one at the end which seemed to suggest that monetary policy was set on the basis of demand, well that is better than saying it was set on the basis of GDP but no, it is really set on the basis of what we think is going to happen to inflation in the future.

Mr TURNBULL—The factor you identified was growth in demand.

Mr Macfarlane—My reference to demand was really to explain why, over the past, you could not say that a slowing in GDP, even if it is literally as big as the figures say, and we think it is not as big as that, you could not say that that was due to an insufficiency of demand. Demand was introduced in that backward looking sense. I was not saying that demand is about to accelerate and it would be very disappointing if that were to happen. We do not think that that is going to happen.

Mr TURNBULL—Governor, I apologise that the question was long, but the point of it really was: how do you think you are positioned, given the economic factors which you have outlined and which we have discussed and with a likely increase in rates, if the US dollar continues to depreciate and our dollar consequently continues to appreciate? The long-term decline of the US dollar, as you said earlier, is the overwhelming story. One would have to expect it to continue to decline. The point I am really making is: given that, isn't there a risk of a double whammy?

Mr Macfarlane—Yes, there is always a risk. These things always have to be taken into account. The future movement of the US dollar is, of course, something that none of us know the answer to, particularly over a period as short as a year. It is impossible to predict and there is no one who knows how to do it. Test after test has demonstrated that. It is possible that the US dollar will go down sharply; it is possible that it will not go down at all; it is also possible that the movement that it has had to date is as much as it is going to have. It has gone down 30 per cent in trade weighted terms, which is quite a lot and it is about as low as it has been in trade weighted terms. None of us know. If it turned out that it does go down a lot more and that causes a lot of problems, then we would have to reassess monetary policy in the light of that.

Mr TURNBULL—If you were certain that it was going to go down significantly in the next year—obviously you are not, no one is—that would be an argument for leaving rates where they are, would it not?

Mr Macfarlane—Yes it would be an argument against rising rates if you were certain that the US dollar was going to go down and the Australian dollar was going to appreciate very sharply. If you were certain of that, that is right. Since we know that not only are we not certain of it, but we do not have any knowledge whatsoever about it, we can not use that as a basis for making monetary policy at the moment.

Mr TURNBULL—You have mentioned that the share market has been booming. Would you agree with me that consumers, both here and in the United States, have shown a very different propensity to consume or not consume depending on the wealth effect occasioned by an increase in rises in shares, unless it is very dramatic—or a fall in the United States—than it is on real estate? The wealth effect seems to be more marked with real estate than shares. You may remember Bill Dudley's work on this after the 2001 crash?

Mr Macfarlane—That is right. The house prices would have a more pronounced wealth effect than share prices, more so in Australia, I think, because a much higher proportion of household wealth is held in the form of housing compared to the US.

Mr FITZGIBBON—I would like to begin by diving a little deeper into this apparent discrepancy between what is happening with real household disposable income and what is happening in the retail sector in particular, notwithstanding that you have questioned those retail

figures. We now have household disposable income growing at about 8.2 per cent which is, I think, the largest rate since about 1989 and we all know where interest rates were during that period. We have this slump in retail figures and no evidence that household savings have increased. I think in the last two months of last year household credit again was on the rise. So my first question is: what is driving these big increases in household disposable income, to what extent do you rely on those retail figures in producing your forecasts and are you concerned about that discrepancy?

Mr Macfarlane—I think what you have demonstrated is the difficulty of trying to get an utterly consistent picture from two or three different sets of economic statistics. They usually do not match up. So you have to bet on one and give it more priority than the others. The reason that household disposable income is so strong, I think is very easy. Employment growth has been extremely high, wages have been growing at a reasonable rate and employment has been very strong. You would expect a strong household disposable income. If we are looking particularly at the September quarter and maybe a little bit at the December quarter, there were tax cuts and there were benefits paid.

Then you say, it has not gone into savings. I think the statistician said some of it did go into savings. The savings rate did go a little bit in the September quarter, not a lot, and it has not gone into retail trade, but where has it gone? As I say, we think a lot more of it has gone into spending than is indicated by retail trade, which is only 40 per cent of consumption. So the other 60 per cent we do not know anything about, or I think we know something about but there are no official figures on them. You could have added a few more things too, you could have said that consumer confidence is at the highest level it has ever been and retailers are very happy with—they are not jumping over the moon, but if things are weak they pretty quickly complain to us and they have not been complaining to us. I quoted those figures from credit card purchases and EFTPOS purchases. I think more has been spent than the retail trade figures show, but some of it undoubtedly has been saved. As I said, the savings ratio in the September quarter did go up, so some of it has been saved and a lot of it has been spent. It is correct to say that the household sector is behaving a bit more cautiously than it did in previous years, it is still borrowing at a fast pace but not as fast as it was in 2003. So there has been some improvement.

Mr FITZGIBBON—On the issue of infrastructure bottlenecks, we have been reminded this morning that it was not only in your February statement in which you raised this issue; you certainly raised it in the August statement of last year. You kindly shared with us when we first met with you the fact that you obviously regularly have conversations with the Treasurer. I find it interesting that the Treasurer appears to have only come to this question in more recent times—it has certainly become an issue in the parliament over the course of the last couple of weeks. Can you tell us whether you shared privately your concerns about infrastructure bottlenecks prior to the last election and whether you have been surprised by the tardiness of the government's response to those concerns?

Mr Macfarlane—There is one bit on which I would agree with you. I think even we were slow to wake up to this one. I think the first time that we really said anything clearly about it was when Deputy Governor Stevens gave a speech in December. That was a bit of a turning point for us. We were a bit slow to wake up. We knew that the volume of resource exports was much weaker than it should have been. I think we knew that was a capacity constraint, because that was in the newspapers. But I think it has really only been in the last three months or so that we

have become outspoken on the subject. As for discussions with the Treasurer, I cannot remember whether we spoke about that or whether we did not, because they are extremely informal discussions—there is never an agenda.

Mr FITZGIBBON—Can we assume that your invitation to join with the cabinet in the next week or so is a reflection of a determination on the government's behalf, I suppose, to take more notice of your warnings in the future?

Mr Macfarlane—I do not think I can speak for the government on that. All I can say is I do not spend much time talking to cabinet. It is not something I do very often, and it would obviously only be at their request. There was a period during the Asian crisis when I think I might have been there a bit more. The last time I was there was two years ago. They did the same thing in 2003 in one of the early cabinet meetings of the year. They brought a whole lot of people in to speak to them, and I was one of them, and they are doing the same thing again this time.

Mr FITZGIBBON—I am interested in the fact that this time around you devoted a whole chapter in your statement to the resources sector. It is fairly obvious that at some point the party is going to come to an end in terms of resource prices in particular. You do not really make much of an attempt to think long term on prices. Are you concerned about our heavy reliance at the moment on resource prices? What impact do you see them having on the current account deficit when they eventually turn down? In fact, are you able to quantify it by, for example, bringing the CAD back to the long-term average and then extrapolating that to the impact that might have on the broader economy? I am saying when prices go down it is obviously going to have a big impact on our terms of trade and some big implications for the economy.

Mr Macfarlane—You are right. With two prices in particular—the coke and coal price, and the iron ore price—the rises have just been phenomenal, and there is more coming that has not fed in yet. It is April or something, isn't it, that some of these things kick in? They are so high that at some point they have to fall. But to offset that there is also fantastic medium-term capacity to increase supply. The reason they have gone up so much is—

Mr FITZGIBBON—The supply would drive prices down.

Mr Macfarlane—Yes, but I am talking from our perspective. The reason they have gone up so much is not because there has been an OPEC type embargo or anything. They have gone up because the world demand is just so much bigger. It is not just the demand this year; it is the underlying long-run demand as these big economies—the Chinas, the Indias, the Russias, the Brazils and all these people—come on board. So, on the one hand, I think if I was in the resource sector I would be saying, as you are: 'These prices can't last forever,' and I would not be looking forward to the day when they fell. On the other hand, I would feel that the long-run basis for my business was stronger than it has ever been and that if I can produce the stuff then, going out decades, demand is higher than I formerly thought it was going to be.

Mr FITZGIBBON—So are you saying in terms of our trade performance that you are not concerned about our overreliance on the resources sector and what is happening with both volumes and prices?

Mr Macfarlane—No, I am not. There was a time, up until about four or five years ago, when there was a widespread view that this was a bad thing—you should not do it; you should have some sort of industry policy which encouraged other non-resource industries to grow at the expense of the resource sector. I was never a fan of that, because I figured that it is very difficult to pick which ones they should be. In fact, back in the late nineties all sorts of people were saying, ‘Our big failure here is that we haven’t got a big enough computer industry and enough computer chips. We ought to get Intel to come in here and build a big factory,’ and all the rest of it. I think that is a risky path to go down. For all the instability that there is in the price of resources, I would prefer the market to make the decision about where they wanted to invest.

Mr Stevens—There is a lot of instability in the prices for manufactures. At present, they are under downward pressure. In fact, the advent of China into the world economy basically has pushed up the price of raw materials and pushed down the price of manufactures. That is the same thing as saying that our terms of trade have risen. Our terms of trade, by the way, are going to go up in the near term by probably eight to 10 per cent. So, yes, they will come down subsequently at some stage, but they actually have further to go up in the near term and we will probably have a situation where we have a terms of trade gain over two or three years of the order of 20 to 25 per cent, which is a very big lift—the biggest we have had for quite some time. As unstable as resources prices can be, so can be the prices of manufactures. Indeed, they are the ones that are suffering, it would seem, in the modern world with the advent of China, with India yet to come.

Mr FITZGIBBON—That is true, but of course the point is that greater diversity is what gives you the buffer against external shocks. Can I ask one more question, Chair?

CHAIR—If you are quick.

Mr FITZGIBBON—Obviously the advent of strong competition policy has enabled us, in the recent past and, indeed, currently, to reach unprecedented levels of resource utilisation. I think there are some concerns that competition policy has slowed down significantly. There are many more reforms yet to be undertaken, particularly within the professions and the government sector. I think there has been some political pressure to, if you like, quarantine some sections of industry. Has the Reserve Bank turned its mind at all to those issues? Is it disappointed that we have dropped the ball on competition policy? Would you be urging the government to pick that ball back up and start running with it again?

Mr Macfarlane—I think my answer to this is going to be the same as my answer to a number of other questions. The purpose of this committee is to make the Reserve Bank accountable. We have to be accountable for what we are responsible for. We are responsible for monetary policy, we are responsible for regulation of the payment system, we have some responsibility for overall financial system stability and we are responsible for issuing the currency. We are not responsible for competition policy. In fact, we are not even responsible for fiscal policy. I am prepared to talk publicly about these other policies insofar as they impact on monetary policy. That is why people always ask me questions about fiscal policy, because traditionally people see that there can be a trade-off between fiscal and monetary policy. But I just do not know enough about competition policy, other than in one little narrow area, which is the payment system, to be able to make any general comments, I am sorry.

Mr FITZGIBBON—What I am asking you is: to what extent has an assessment of the lack of reform in competition policy impacted upon your forecasts about the economy and what you are likely to do in the next little while on interest rates?

Mr Macfarlane—I do not think we have found a way of getting competition policy into our methodology of interest rate determination, I am sorry.

Mr CIOBO—Governor, I apologise for missing your opening statement, but you will be pleased to know I have been reading the papers, so I thought I had a pretty clear indication of what the RBA's thinking was. Having had a chance to review your opening statement, I want to examine in a little more detail some of the comments you made about inflation. In the RBA's February statement on monetary policy, you indicate that the pick-up in inflation will be gradual and forecast it to reach three per cent next year. You cite, among other things, the fact that higher employment costs may put the forecasted inflation rate too low. Similarly, in your opening statement you made some comments that you have not seen an acceleration in across-the-board wages but indicated that there is anecdotal evidence to that effect. I am interested in teasing that a little further. In terms of across-the-board wages, do you think you are not seeing an increase in wages pressure in the same way you believe that retail spending is not an indication of what is actually taking place?

Mr Macfarlane—I do not think that there is anything wrong with the official figure—the wage price index—for wages, or the enterprise bargaining figure. I do not think that there is anything wrong with them. I think they are probably a perfectly good series. I think they will be one of the last things to show where pressures are occurring. You do not have the luxury in this job of simply waiting for the Bureau of Statistics to put out a figure and then saying, 'Now I've got the truth, I will do something.' You are always trying to anticipate what is happening. Sometimes what you are trying to anticipate will turn up in the statistical series quickly, sometimes it does not turn up at all.

The evidence on wages is not just anecdotal; it is not as though it is just a few stories. I do not think anyone disputes that there are very serious shortages in some areas, that there are businesses that are having to find all sorts of ways of paying more to get staff—and so they should. I do not think anyone disputes that. We record all the stuff we read in the newspapers. As I said, we look at all the surveys. We actually speak to at least 100 businesses a month in a formal survey and this stuff is coming through. So I think this is the normal way you would get this. If you are trying to be forward looking, this is the normal first thing you would get. You would get it from those sources and then potentially you would get it later in the series.

The problem with waiting—and I am not sure that you are even suggesting that we should—until such time as something is so irrefutable that you can see in the wage price index that it has moved up to a new level, is that it is actually embedded in the system by then and it is extremely difficult and costly to get it out. Most of your time is not spent looking at the ABS statistics; most of your time is spent trying to find out what they eventually will look like when they come out.

Mr CIOBO—Forecasting, in other words. Is the forecasting the RBA is doing essentially underlying the concern you stated in your opening statement when you said that over the longer

period it seems that inflation has now reached a trough and is showing signs of turning up, coupled to a certain extent, to your concerns over capacity constraints?

Mr Macfarlane—We had been forecasting for some time that inflation was going to follow a sort of ‘U’ shape: it was going to come down, reach a trough and then it was going to go up. We have been saying that for more than a year. We have always said the trough was going to be around now—around the end of 2004, beginning of 2005. We thought the trough was going to be as low as 1½ per cent. In the end, it did not turn out to be as low as that; it turned out to be 2¼. The actual has had to be revised up a bit as we have gone along. We still have a ‘U’ shaped pattern and we have made it much more shallow because the bottom of it has been moved up. What we are saying is, ‘We’ve moved the first leg of it up; we really haven’t moved the second leg up.’ That might be wrong. That is why we think the risks are on the up side rather than on the down side.

Mr CIOBO—Given the scenario you have painted, and given a suspicion that wages are going to be a large factor, would you care to comment on the importance of increased labour flexibility with respect to its potential impact on monetary policy going forward?

Mr Macfarlane—What I would like to do is perhaps save that until the second half, if I can. I think someone else brought up a subject which I said I would like to save until the second half. I think one of the things we should talk about in the second half is: if you really feel you are after this really long expansion, you are now being capacity constrained, all the pressure comes back on supply. You have to think about supply rather than demand which is what we have been thinking about in the past. I think that opens up a whole range of things that you have to think about. As I said, they are things which I can list, but I am not an expert on any of them. Opinions will differ on them, but it certainly would, I agree, bring industrial relations into the forefront.

CHAIR—We will have an opportunity to further discuss monetary policy in the next segment. Obviously, we will also be discussing the issue of payments. Would the students mind preparing their questions or come forward to me or the deputy chair and we will ask two questions on your behalf. Please include your name and the school you are from. Unfortunately we cannot offer morning tea to everybody due to the government’s fiscal restraint. We will resume in about 10 minutes.

Proceedings suspended from 11.45 a.m. to 12.11 p.m.

CHAIR—We will continue with our questions. Perhaps members of the committee have further questions on money policy before we move on to the payments areas. I have a couple of questions about where we were in the inflationary graph. We were starting on the upside. You mentioned in your statement that by 2006 you expected us to be at three per cent inflation. Where do you see us beyond 2006?

Mr Macfarlane—The answer to that is, if we do our job properly, it will not go up much further than that. I do want to emphasise, however, that with our inflation target, it should average somewhere between two per cent and three per cent. We are not saying that it is never allowed to get outside two per cent and three per cent—in fact, 45 per cent of the time it has either been above three or below two—but, if it is above it, we like to think there is a process in train that is bringing it down again and, if it is below it, we like to think there is a process in train that is bringing it back again. We do not want it to get too far away from those numbers; that is all.

Can I also mention something else. Several people pointed out to me that I made a mistake in answering a question on fiscal policy—that, instead of saying that the latest estimates for the budget surplus in 2004-05 are for a bigger number than the initial estimates, I said that it was for a smaller number. The correct meaning of what I said was the expectation is that the budget surplus will now be a bigger figure than it was thought to be at budget time.

CHAIR—The second issue was: if no corrective action was taken through interest rates or other measures, where would we be at next year?

Mr Macfarlane—What particular variable are we referring to?

CHAIR—The economy.

Mr Macfarlane—Economic growth?

CHAIR—Yes.

Mr Macfarlane—It is a difficult period to be forecasting this. Our feeling was that, if you had never heard of the concept of capacity constraints and you were making a conventional forecast for calendar 2005, you would probably come up with a number for GDP of 3½ or something like that. But our guess is that it will be lower, because the capacity constraints are having an impact. Something nearer to three might be more likely than 3½.

CHAIR—The final question is related to an issue you said you would speak about later. The focus has been on the demand area and the restraints that may be necessary. We did not speak at any great length about the supply issue and the issues we should be looking at with respect to the development of the Australian economy.

Mr Macfarlane—A couple of questions came up which really led into that. However, I thought it was such a big topic that I did not want to break the train of thought by trying to answer them at that time and that it would be better to wait until the second session. In some

sense I am getting outside my area of expertise. I am not an expert on the supply side of the economy. Monetary policy is really all about operating on demand. We have to take the supply side, the capacity of the economy to grow, as a given. We cannot really affect that with monetary policy. What we try to do is make sure that demand does not outstrip the capacity to supply by too much. But the supply side of the economy is now becoming more important. That is the theme of this document and it is the theme of my introduction: we are now entering a phase where this is becoming much more important than it used to be.

We have to think about supply-enhancing policies. What can you do to enable the output of the economy to grow faster than it appears at the moment that it is likely to grow at? You do not have to, but I suspect the public would like that; they enjoyed a long expansion where GDP growth was 3.7 per cent per annum. I think they would be disappointed if we have to settle for something considerably less than that and they would be sympathetic to us introducing some policies that return us to a position where we have a capacity to do that—maybe not 3.7 per cent, but maybe 3½, or something like that. People would be receptive to that. I think they would be disappointed if they were told, ‘It’s clearly going to be a lot less than that; don’t expect anything like that in the future.’ Therefore, I think they are looking for some policies to improve the supply side of the economy.

You have to affect one of three things: you have to affect capital through new investment, you have to increase the supply of labour or you have to increase productivity. You have to affect some, or perhaps all, of those things. I will start with investment. You can think of investment as being made up of business-fixed investment, which is what most people think of; infrastructure, which may be public or private or some mixture of the two; and of course housing, building new houses and renovating existing houses. As I have said, over the last three years or so if you look at the growth figures for investment they look quite good because they have gone up by three percentage points of GDP, but 1.7 per cent of that was housing. If you look at business-fixed investment and infrastructure it does not look anywhere near as impressive. So when we decry the lack of infrastructure and sometimes business-fixed investment we should recognise that in this country we have an incentive system that directs what I think is a disproportionate amount of our investment resources into housing. People should look at that.

On business fixed investment, I think the outlook is quite good. We know that there was not enough investment in the resource sector, particularly back in 1998-99 or 2000 there was not enough investment undertaken that would be coming on stream now. As I said, we should not be too critical, because resource companies were not earning very much money then, nobody wanted to lend them money and nobody foresaw that the growth of demand would be as big as it has been. But I think the outlook there is quite good.

On infrastructure, I do not really want to weigh into this debate because, as I said, I am not an expert. But I do seem to get the impression that a lot of the investment in water, power, transport, ports et cetera is being questioned: have we done enough? Without giving an answer, that has to be a subject that we look at very seriously. Everything that I am saying, I do not have answers for. I am drawing up an agenda for what I think people should look at.

On labour, the thing that stands out there is the skills shortage. We hear it constantly, although I think in some areas people are saying they also have trouble getting unskilled labour. But the biggest thing that stands out there is skills shortage. Everyone says that we are particularly short

of tradespeople and that the ones we are relying on are getting older and older and there are just not enough of them in the pipeline. Everyone knows this, and I think it is well known in Canberra. Things are in train. The question is: is enough being done about increasing the relative attractiveness of trades vis-a-vis white collar occupations? So that is the first thing—that the supply of skilled labour is high on the agenda.

Welfare and tax reform have to be high on the agenda, largely because they are having an effect on labour force participation. I think they are holding it down. We have got a very low labour force participation rate by males over the age of 45 by world standards. It is something to do with taxes and retirement incomes policy. Again improvements have been made there but it still has to be on the agenda. At the lower end, there are obviously very large obstacles in terms of high marginal tax rates and withdrawal of benefit rates for social security beneficiaries who wish to enter the labour force. A group of five economists wrote a very good piece on that a couple of years ago but it seems to have been shelved. That should be brought back and put on the agenda. We have 600,000 people on disability pensions who have, as far as I can see, no need to be reviewed. The current legislation means that there is no need for review there. I think that is another thing that has to be on the agenda. Whilst we are talking about labour, I suppose the other thing that has to be there is migration. That is not going to be a permanent solution, I do not think, but it may be a useful solution. I am sure if we opened up each one of these issues to debate, no-one would be able to agree on any one of them. As I say, all I am doing is suggesting an agenda.

Productivity is the final thing. We have done pretty well in terms of increasing productivity over the nineties. It is slowing down a bit at the moment. In fact, if you literally read the GDP figures and the employment figures, they would be telling you it has suddenly plunged to being negative, which is another reason why I am a little bit dubious on the GDP figures. The biggest thing in this area is industrial relations reform. There must be a lot of things that still can be done. From my own experience in the Reserve Bank, as we have changed things and reduced our size and, I think, increased our productivity enormously, one of the things that stood out was that there were a lot of benefits and rules which were of some benefit to employees—but a very small benefit—but were extremely costly to the employer, which means that there is a classic opportunity for a win-win situation as these things are resolved. That is the end of my list. I only mention this because I do not think I could have come to this group and said, 'The most important thing is not demand; the most important thing is supply, but I do not have a word to say about it.' The best I could come up with, being a nonexpert, was just to give a list of what I thought was a reasonable agenda.

CHAIR—That is very interesting. Thank you.

Mr BOWEN—Could you turn your mind for a moment to the US economy and its impacts on ours. I read recently that one of your former central bank brethren, Paul Volcker, predicts a 75 per cent chance of a financial crisis in the US in the next five years due to the unsustainable twin deficits. Do you agree with him? What would the impacts of the ongoing unsustainable twin deficits in the United States be, even if we do not get to a crisis—its impacts on the world economy and us? That is another small question for you.

Mr Macfarlane—First of all, I would never like to argue with Paul Volcker because I admire him enormously. If anyone has ever seen him, there is another reason why you would not want

to argue with him. He is about six foot eight. I think that there are always big risks to financial stability. You always have to worry about these, and I think countries are spending more and more time trying to anticipate these risks. The US budget deficit is a more worrying development to me than the US current account deficit. I suspect the rest of the world will continue to finance the US current account deficit and if they decide they do not want to, the main thing that would happen would be a fall in the US dollar. I do not think that if there were a big fall in the US dollar, the Fed would necessarily react to it. The US is less influenced by their exchange rate than any other country. Most people in America would not have a clue what the US dollar exchange rate was because they are not even aware of the other currencies that it should be compared to. As far as they are concerned there is only one currency: it is the US dollar.

I think, in the long run, the US fiscal position is very worrying. The US does not have a very good record on fiscal policy. They have had very few surpluses in the last 30 years. But the other worry which I think Volcker, knowing his views and his background, would be alluding to is the sort of phenomenal growth in the sophistication of financial markets and the complexity of the products and the fact that they have become so complex that a lot of people are taking risks that they are not aware of. That would worry me more than either the current account deficit or the budget deficit. But of the two, I would be more worried about the budget deficit.

Mr BOWEN—To change tack, I wanted to ask you about the impact of interest rate increases in the coming period. We have interest servicing rates of about nine per cent of household income, which I think is the highest it has ever been. There is also a matter that we have discussed privately: the rise of bank lending against home equity for non-home products, so people are borrowing for holidays and boats against their home equity. At least if they are borrowing for renovation or for a new house, they are increasing their wealth so that they have a little bit of a buffer when the interest rate rise comes. If they are borrowing against their home for boats and holidays, they have nothing to fall back on. That is something that concerns me greatly and indicates to me perhaps a harder landing than we would normally have through an interest rate increase. I think there are some figures out this morning showing that that lending has fallen off a bit, perhaps in response to your warnings about coming interest rate rises, but it is still very high. I wanted to ask you to flesh out whether this is a concern for you. Is it one of the things perhaps that has led you not to increase interest rates yet, because you think the impact will be higher than we saw even in the early 1990s from increased interest rate rises?

Mr FITZGIBBON—Can you add to the risk any concerns you might have about the increasing external indebtedness of the banks themselves?

Mr Macfarlane—We have three questions there. I think I have forgotten what the first one was!

Mr BOWEN—It was the debt servicing ratio and then lending on non-home products.

Mr Macfarlane—The second one is what is called mortgage equity withdrawal. That is a good sign. A lot of that was happening and it appears that in the September quarter that may have stopped. It does not mean that households were not borrowing; they were still borrowing at a fair clip but they were borrowing for housing rather than borrowing for housing and then a bit more on top of that for the holidays and boats that you were talking about.

The debt servicing ratio of the household sector is 9.3 per cent at the moment. It is the highest it has been. The previous time it was anywhere near that was because mortgage rates were 17 per cent. It is quite an achievement to have a higher debt servicing ratio given that mortgage rates have fallen so much. We have made it clear for a long time that we are aware that the fact that the household sector is carrying so much more debt means that monetary policy is, in some sense, a more powerful weapon and has to be used sparingly and delicately. I think that is the implication that comes from that. It is not that you cannot use monetary policy but it has to be used very carefully because it is bound to have a bigger impact on the household sector than it had in the past. The final one was banks borrowing abroad—

Mr FITZGIBBON—And the implications for the current account.

Mr Macfarlane—The fact that our investment went up and our savings went down means we have a current account deficit, which means we have to borrow from abroad to make up that difference between our investment and our saving. That is just an identity; it just has to happen. Whenever a country has a current account deficit they have to borrow from abroad.

There are two issues here. There is one which is frightening but it is not relevant to us—that is, if the borrowing occurred in foreign currency then you are very vulnerable to a financial crisis. A large part of the Asian crisis was that they had borrowed in foreign currency. When their exchange rates went down, their debt burden became so huge that they simply could not pay it back, so businesses went bankrupt. That is not the case in Australia. Virtually every bit of borrowing, whether by the banks or others, is either borrowed in Australian dollars or is hedged back into Australian dollars. So we are not carrying currency risk there. The really big risk is not with us.

So what you are left with is a different and much lesser degree of risk, and it is the same risk you are left with in any investment: did I make a wise investment and is it going to give me a rate of return that is going to make it comfortable for me to service my debt? That is why I am a little disappointed that so much of the increase in our investment was in our own houses. It does not mean we cannot service the debt; it just means it would have been easier to do it if we had been putting it in business fixed investment which was earning a high rate of return.

But that is a decision that the household sector took. As you know, it is one where we probably put too many of our resources, not necessarily into our own homes but into a particular form of business, which is the business of buying an investment house or apartment for rent with the intention of making a profit. That is just a business decision, the same as BHP developing a mine or a factory putting in a piece of equipment. It is a decision that happens to be a particular type of business decision which I think will actually yield a low rate of return. So I think it is disappointing that we put so much of our investment resources into that particular activity.

Mr FITZGIBBON—But the banks are not hedged ad infinitum. Therefore, what you do in the next little while will have implications for them and their borrowings. There is an extent to which hedging offers protection, particularly post any move you might make in the future.

Mr Macfarlane—The hedge is only a hedge against foreign currency; it is not an interest rate hedge. It is a hedge against the currency exposure. Whether the currency moves up or down they will not incur a cost.

CHAIR—I know we have questions from Mr Robb and Mr Tanner, but I remind my colleagues that we do want to move on to talk about payments.

Mr ROBB—In the context of the inflation outlook, we saw recently a wage decision involving ENERGEX in Queensland, where electricity workers were granted a 31 per cent pay rise over the next three years. I would be grateful for your view of the importance of wage claims being linked to productivity, the importance that we have seen of that in terms of inflation performance over the last two years and then, by implication, its significance in going forwards.

Mr Macfarlane—I cannot really comment on that claim, although it got a lot of publicity. My understanding was that they thought they were going to lose all their linesmen. That was a classic example of the shortage of a particular type of skilled labour. I do not know what sorts of productivity offsets, if any, they got in that case. I think your point is that, if that sort of thing became widespread without productivity offsets, it would be very inflationary.

Ms GRIERSON—Governor, I take you back to your capacity and supply comments. There are some regions in Australia—and I think I am from one of those—that are already linked to all the factors you mentioned. So we have a regional economy that is vulnerable as well. You have mentioned the port constraints in Newcastle and the infrastructure constraints. We have the skills shortages; we have the vulnerability to resource prices—if China cannot sustain its economic growth, or chooses not to.

We would think that there is a relationship between monetary policy and that area of supply that sees the boom and bust and the potential for that felt in some regions more than others. Do you collect data on that? Do you have advice on how to ameliorate that pain for regions in Australia? Do you have a view on that?

Mr Macfarlane—What you have described to me does not sound very painful; it sounds as though you are in a booming region.

Ms GRIERSON—We have got the boom, but we do not want the bust.

Mr Macfarlane—I think a lot of regions would like to have those problems.

CHAIR—It is all the government's fault, of course.

Mr Macfarlane—I have not got any particular advice for the Hunter region at all other than to repeat that what you have described is, in some sense, the results of success rather than the results of failure. If you are as successful as you have been, I suppose you can always worry that things might turn around at some stage. Again, you mentioned the resource sector, because there is a lot of coal mining there. People have a capacity to think that they are hard done by when they are actually doing really well. Most regions would love to have a really strong industry with such terrific long-term, decade after decade, prospects. Even if prices fall from the giddy heights they are at at the moment, I think that is a small price to pay for the benefit of having such a strong export sector in your area.

Ms GRIERSON—We hope that is what happens and that our economic growth continues and sustains, but we do also feel interest rate rises pretty highly, given the lower income levels in

regions. The other thing, Governor, that you raised is labour markets. It has been suggested by one organisation that, over the next 40 years, with the shrinkage in the work force, that could translate to a 1½ per cent reduction in our GDP. Do you have a comment on that? How do we sustain what we have had, which has been some better behaviour by wages, through a period where we are seeing pressures on the labour force?

Mr Macfarlane—We are getting into the really long run when we talk about ageing of population and dependency ratios and all that. I do not know that I really know enough about the subject, but I think a lot of it gets down to something which I have already brought up—something which is dear to the heart of Ken Henry, the Secretary of the Treasury—which is labour force participation and removing obstacles that presently exist whereby people who may be interested in being members of the labour force are not members of the labour force. I think that covers a wide range of practices and retirement incomes, tax, benefits—all sorts of things, none of which I am an expert on. But it is pretty clear that, if you have an ageing population—and we have a much smaller one than virtually every other OECD country—increased labour force participation is a crucial part of the response.

Ms GRIERSON—And the fact that wages have been kept down? What do you attribute that to during this period?

Mr Macfarlane—Real wages have grown. Each year, real wages grow faster than inflation, but there has not been a wage explosion. There has been nothing like what we had in the seventies or the very early eighties. On the other side of the coin is this fantastic reduction in unemployment from nearly 11 per cent down to five per cent. I think that has been a great success.

CHAIR—We have a couple of brief questions, firstly from Lindsay Tanner, Steve Ciobo and Malcolm Turnbull. Then we really need to move on.

Mr TANNER—Governor, as far as I recall this morning, we have not mentioned the stock market in the discussion. I note the figures that are in the statement, which I am sure everybody is aware of, are very strong, but the PE ratio is up to 21 compared with the long-run average of 15 or 16, and marginal lending is up 21 per cent. I think there is 23 per cent total growth from the beginning of 2004, from memory. Given that you appear to have successfully slowly deflated one asset price bubble, do you have any concern about the possibility that we may see signs of that in equities, that the bubble may have just moved?

Mr Macfarlane—Yes, there is something in that, in that 2004 was a year where a lot of household investment which had formerly been going into investment property moved into the stock market, and so we had a very strongly performing stock market and a flat housing market. Overall, that was a very good thing, because it was the housing market which was most overheated and which was having the most difficult effects on the population, on people attempting to buy the first homes. So that was a great success. Has it gone too far? Has too much money moved into the stock market? I do not know how to answer that. I think I did say before that I do not think there is evidence, because although the PE ratio is higher than average it is not exceptional. Most of the big rise in the stock market has been accounted for by the fact that earnings have gone up so much.

You mentioned that margin lending has risen quite strongly, by 21 per cent over the last year. That is true. That is a sign, again, of money moving into that market. But margin lending, even though it has grown, is from a small base. It is 15 per cent of personal borrowing and it is about two per cent of total household borrowing, so it is still quite small, although it is growing quickly. I have to say I have had none of the serious reservations about the stock market that I had about the housing market. I might be wrong. I had very serious reservations about the housing market, particularly the investor housing market. I do not have the same reservations about the stock market, although some people may say it is already fully priced.

Mr CIOBO—Governor, I welcome your comments on supply side enhancing policies, especially with respect to labour force participation and the gingery issue of tax and welfare reform. My questions are about clarifying a couple of comments you made about current levels of household indebtedness. I understand that you have done some recent stress testing that basically indicates that the current level of household indebtedness is not of major concern with respect to being a threat to the economy in ways that it perhaps was previously seen in Australia in the late eighties. Would you care to comment on that?

Mr Macfarlane—What the stress testing was looking at was one particular form of distress. The stress testing was carried out by APRA and they were asking the question: ‘If there was a very large fall in house prices’—I think they fed in 30 per cent or something—‘would that be big enough to bring down major financial institutions, like major banks?’ They found that it would not. I think that result is correct. People in other countries have done this too, and they generally find that. But that is the only form of stress they are testing for. They are not asking other questions. We have always agreed with that, but we have always felt that the vulnerability that an economy faces as a result of a very high level of household debt is not that people are going to stop servicing their mortgages and that banks are all going to go broke because they have these non-performing loans. We have never thought that was the risk.

We have always thought that, if people are heavily indebted and they are paying very high debt servicing, the real risk is if something comes along, like a recession, and interrupts their cash flow—in other words, people start losing their jobs or they have to take lower paying jobs, where they simply have not got enough money. Then what we think you would see would be a really big fall in consumption. So I think the household indebtedness—someone else alluded to this earlier—has made the household sector more cyclically sensitive to any downturn than it formerly was. As long as they have a job, most people will continue to service their mortgage whether the house price has fallen or not or whether the interest rate has gone up or not. The crucial danger is if they lose their job. Then I think the main effect we would see would be on spending: consumption spending would fall very, very sharply.

Mr CIOBO—The offsetting confidence measure is the fact that unemployment is now significantly lower than it was when we have had similar situations in the past.

Mr Macfarlane—We have not had a similar situation in the past. In the 1980s recession, the household sector did not play a very big part at all. That was a boom and bust in the corporate sector. The household sector did slow down of course but the triggering event, the excessive debt story of the eighties, was the corporate sector and not the household sector. The household sector had very modest levels of debt at that time; the Australian household sector was a very

conservative household sector. This is the first time we have faced a situation with a household sector which is pretty heavily geared. We have not had that before.

Mr TURNBULL—Governor, I want to turn to payments.

CHAIR—Can we make sure we have exhausted this first? Also I want to go through the school questions before we get onto that. Do want to ask your micro question?

Mr FITZGIBBON—Absolutely, Mr Chairman. It is absolutely the question that has to be asked. Governor, notwithstanding your earlier comment that the relationship between fiscal and monetary policy is largely an irrelevant one, can we seek your opinion on which of the major political parties took into the last election a policy which had the least implications for monetary policy?

CHAIR—I do not think it was worth waiting for the micro question.

Mr TURNBULL—The people answered that!

CHAIR—Yes, that is right; we have already decided that one.

Mr Macfarlane—I do not know how to answer it, so it does not matter.

CHAIR—More importantly, we have some good questions from three schools which we have chosen. The first question is from Caringbah High School, which I think is where Deputy Governor Glenn Stevens sends his daughter. This question is from Michael Barry:

Mr Macfarlane, earlier today you talked of the inability of business to procure both skilled and unskilled labour. We now have our FTA worked out with the US and talks starting in April with China and Thailand, all of which will undoubtedly demand many new jobs. Does the Australian economy have the capacity to fulfil these potential positions, especially given the slower growth indicators? With current inflationary indicators showing upward pressure in the short- to medium-term will these jobs, if generated, lead to the need for further interest rate rises?

Mr Macfarlane—My guess is that the effects of the free trade agreement with the US or any free trade agreements that are currently being negotiated in Asia will take a long time to feed through. I do not think they are an immediate threat to us and certainly they are not something that we would need to take into account in our monetary policy setting.

Mr BOWEN—I have a series of very good questions from schools in the Prospect electorate. I will ask the first question I was given, that is the only fair way of doing it. Governor, this question is from Hosna Girowal and Michelle David from St Clair High School:

How will increased interest rates impact on our restricted resource capacity? That is to say: are you worried that an increase in interest rates will reduce the willingness of people to borrow to invest in infrastructure?

Mr Macfarlane—The first thing is monetary policy acts essentially on demand; it does not really act on supply. The second answer is: yes; to the extent that interest rates are higher one of the effects that monetary policy would have would be, at the margin, to reduce people's desire to borrow. That is one of the ways in which it works.

Mr TURNBULL—Wentworth electorate schools are here in force and this question has been given to us from Cranbrook and Kambala, who are obviously having a collaborative exercise:

Given that the Reserve Bank has a chartered commitment to full employment, can an unemployment rate of 5.1 per cent be considered full employment? Will the Australian economy ever be able to return to the unemployment rate of around two per cent, as it was in the 1970s?

That question was written by Michael Deane.

Mr Macfarlane—That is a very good question. None of us really know the answer to it. The reason it is a good question is that, if someone had asked the question six or seven years ago when the rate of unemployment was eight per cent or something, they might well have said: ‘Would it ever get to five?’ and a lot of people would have said, ‘No, it couldn’t get to that; that’s too low.’ In fact, it has got to five. Will it go below five? Yes, it may. Will it get to the sorts of rates that we had in the fifties and sixties? I would be surprised to see that happening. A massive number of bits of legislation would have to be unwound for that to occur. I think it was a much simpler society then. There were many fewer impediments to employing people and many fewer inducements for people who wanted to enter the labour force to enter the labour force. But it may well go below five. I do not think there is anything magic about five.

CHAIR—To all the schools who have participated today, thank you. Your questions have been of high quality, which promises well for the future. Moving onto payments, Governor, could you outline some of the recent developments in terms of reform of the payments system since your statement mid last year?

Mr Macfarlane—We have an act—and a Payments System Board—which says that we are responsible for the prudence, the competition and the efficiency of the payments system, which includes not just the centre of the payments system—the wholesale bit; the real time gross settlement bit—but also the retail payments system, which is unusual. The retail payments system consists of five main streams. There are five basic ways you can pay for something if you need to: cash, cheque, credit card, debit card—which is often called EFTPOS—and electronic debiting and crediting. They all have different virtues and different vices and they all have very different costs.

When we started down this path, one of the first things we noted—which concerned us somewhat—was that the most expensive of those five was the credit card. In other words, each time you make a transaction with a credit card there is a bigger transfer of income from the bank’s customers to the bank than there is with the other methods. Yet that was growing faster than the other four methods. We did not believe this would be the outcome that you would get in a purely competitive market if the decision makers were able to face prices which represented the true costs.

The first thing we identified that we should do some work on was credit cards. That was completed by the time we last met. We had reduced this hidden fee called the ‘interchange fee’ by nearly a half. That flowed through in the form of about \$500 million less flowing to the banks than before the fee was reduced. We then looked at the other payments instruments to see whether we thought any other things which we thought were distortions.

The main thing we saw—which I think is going to bedevil our payments system for a very long time—is that, unlike other countries, we have a debit card where the interchange fee flows in the opposite direction to the credit card one. So each time you use a debit card or EFTPOS, the issuer, which is your bank, does not actually receive any income as it does with a credit card; it has to pay out. So we felt that, in the long run, if this continued and the gap was as wide as it had been, we would face the risk of the debit card or EFTPOS card system atrophying, dying. Either the banks would have to charge you—some of the banks already charge you for using your debit card because it is costing them money—or those that do not charge you would be reluctant to issue in the long run. It would not be an important part of their business strategy to issue these cards which are costing them so much money. So what they will do is try to push everyone into credit cards.

That has been the major focus of our work. It has not been easy. Nothing is easy here. We thought we had made a big breakthrough when the issuers of the debit cards themselves decided that they would do away with this particular fee. Getting rid of a fee is classified as a form of collective price setting—to get together and say, ‘Let’s make this price zero’ is actually a form of price setting. They had to get ACCC approval. They got the ACCC’s approval but the merchants—particularly a couple of the very big merchants—did not like this result because even though they had gained a huge amount from credit cards they were going to lose a bit from the reform to debit cards so they took the ACCC to court and they won the case. So it has not been possible, through voluntary agreement, for the card issuers to reduce the fee to zero.

We are looking into it now and we will be putting out some proposals shortly—possibly next week—for people to comment on and give us their views. Then we will decide what we will do. In the meantime, just as the credit card schemes—Visa and MasterCard—took us to court when we reduced their interchange fee, the merchants are taking us to court over the fact that we are actually doing anything at all to the EFTPOS debit card. That will commence later in the year. I have to be rather careful about what I say. If I say the wrong thing it will be used in evidence against me.

CHAIR—I appreciate that. We have obviously been subject to some significant lobbying by the credit unions, who are concerned about the Visa debit cards.

Mr TURNBULL—Governor, you expressed confidence or hope that competition will ensure that new lower fees will flow through to merchants and ultimately be reflected in the prices that consumers pay at the point of sale. How can that happen if the different fees involved are not transparent to consumers at the point of sale?

Mr Macfarlane—That is a very important point. One of the great difficulties in the card payment system is that the merchants tend to feel relatively powerless when they are negotiating with the big card schemes. They feel that if they do not accept the card they will miss out on a lot of sales. So they tend to accept them even though they feel the fees are far too high and they wish that people did not use this particular form of payment. The cardholder on the other hand has no idea how much the merchant is paying. As far as the cardholder with the credit card is concerned it is free: ‘I can use this; this is a free instrument.’ It is free to the cardholder but it is not free to the merchant. In fact, for the cardholder in some cases not only is it free but they are receiving a benefit—they are being paid to use it. The high amount the merchant pays is transferred across to the card issuing bank which then gives points to the user—frequent flyer

points and things. In some sense this is the heart of the problem. The decision maker, which is the cardholder, does not know what the costs or benefits are to the community. They naturally just respond to the price signal they see, which says, 'This is free. I am actually going to be paid for doing this.'

The simplest solution we have found, and at the moment it is in its infancy, is to override some contracts which formerly the card schemes had with merchants, that prevented them from passing the cost on to the consumer. They called it the 'no surcharge rule'. It was an agreement whereby the merchant said, 'I've got to absorb this into my own costs. I'm not allowed to reveal to the cardholder what it is or ask for compensation from the cardholder.' We regarded that as a serious constraint on trade and got rid of it, but it is still the case that the vast majority of merchants will not pass through the cost to the purchaser. They would love to, but they feel they cannot. If you were a merchant and someone came in, and they had two different ways of paying for something, one of which would be very expensive to you and one of which would be very cheap, you would like them to pay more if they used the expensive method rather than the cheap method.

Merchants are now allowed to do that. They are now allowed to say: 'If you want to pay me using an expensive payments mechanism, I'll charge you a little more than if you use a cheap payments mechanism.' But because this was not allowed for 50 years and habits have tended to absorb the idea that you should never be charged for using an expensive payments mechanism—in other words, that user pays should not apply to the payment system—not many merchants are doing this.

It is happening at the two extremes. Some of the very big players, like Telstra and Qantas, are doing it, and at the very competitive end—the classic being computer shops and some of the white goods shops—where their margins are very low, they are also passing it on, but the 90 per cent in the middle are not. I think they should. I think consumers will be much better off in the long run and the payment system will be much cheaper for all users if the users actually see and have to pay for using an expensive payments mechanism rather than a cheap one.

Mr TURNBULL—In your ideal world, all prices quoted by retailers would be the cash price, and then there would be a surcharge depending on which alternative payment method was used?

Mr Macfarlane—That is one solution to it, yes. In the other solution, if the retailer had time to adjust their prices, they could do it via a discount for using a cheaper payments mechanism.

Mr ROBB—Governor, I am reasonably familiar with many areas of banking, and my observation is that there is tremendous competition in so many areas of banking. I am not that familiar with the payments area. My introduction to it suggests that there is not a lot of competition—there is nowhere near the competition that we are seeing in so many other areas of the banking sector. Are there barriers to entry to the payments sector, whether it be cross subsidies or tax breaks? Is there anything there which makes this part of the banking sector appear to be somewhat less competitive than the very aggressive competition I see in other parts of the banking sector?

Mr Macfarlane—Yes, there are barriers to entry. A classic area where there is phenomenal competition is lending for mortgages, because there are 30 banks and 200 mortgage brokers, and

obviously there is intense competition there. When you get to the payments system it becomes more complex, because the payments system is a network. You cannot have 30 different networks. For example, with credit cards or similar cards to credit cards, you really have about three: Visa, MasterCard—Bankcard is still there, but it is not as big as it used to be—or Amex. So you really have quite small numbers, and it would be very difficult for a new entrant just by definition, just because of the nature of those things.

In other areas, there should be room for competition, but there are other things that make it difficult. The one that is concerning us at the moment is debit cards—not necessarily issuing debit cards but going to the merchants and—this is called the acquiring—saying, ‘I will be your bank’—the merchant’s bank—‘and I will look after all the debit card payments and receipts you get.’ There are a number of banks that do that, but, if you were a newcomer and you were not a bank and you wanted to enter that area, you would find it very difficult to do it, because you would have to sign a separate agreement with each of the current members of that network. So you would have to sign a separate agreement with 20 different people who are your competitors and who have no interest whatsoever in signing an agreement with you—or are certainly in no hurry to sign an agreement with you or do the testing and all the rest that is necessary.

I think we will be able to do something about that, because the best form of regulation is actually not regulation; it is just to open things up to competition, and particularly to open things up to competition from outside the club, not within the club. If you remember mortgages: there were always a number of banks that offered mortgages. The real competition came when a nonbank, Aussie Home Loans, came in and competed against the existing group of banks. So we think that, if you want competition to do its job, you really have to have not just a lot of players but it open to the players who are outside the existing club.

CHAIR—We have probably exhausted our guest today. We would like to thank you very much, Governor, for your time spent with us today. It has been outstanding. I would like to thank all participants, particularly the Governor, for his time and his expansive comments. To the other witnesses who came from the Reserve Bank: I appreciate you all participating.

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

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 1.07 p.m.