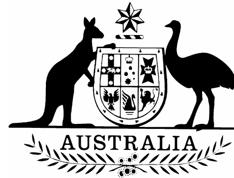

COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2004

FRIDAY, 12 AUGUST 2005

MELBOURNE

BY AUTHORITY OF THE HOUSE OF REPRESENTATIVES

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 12 August 2005

Members: Mr Baird *(Chair)*, Mr Bowen *(Deputy Chair)*, 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 Somlyay, Mr Tanner and Mr Turnbull

Terms of reference for the inquiry:

To inquire into and report on:

The 2004 Annual Report of the Reserve Bank of Australia.

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 10.00 am

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 (Mr Baird)—I declare open this hearing of the House of Representatives Economics, Finance and Public Administration Committee and I welcome representatives of the Reserve Bank, the students and staff from universities and secondary schools in the Melbourne area, members of the public and the media. The hearing today comes at an interesting time in Australian monetary policy. It follows the Reserve Bank's decision to increase interest rates from 5.25 to 5.5 per cent following our last meeting. This was the first increase in interest rates in 16 months, and the Governor today will have the opportunity to elaborate on the reasons for this increase. We hope there is no cause and effect between meeting with the committee and increasing interest rates today.

Other issues we will discuss today with the Governor include an update on the supply side constraints; the level of housing related credit, which increased by a further $2.5 billion in June 2005; the impact of the world economy on Australia; the decision by China to revalue the yuan; the continued lift in US interest rates to 3.25 per cent; and the progress on reforms to Australia's payment system.

Once again on behalf of the committee I welcome the Governor and other senior officials of the Reserve Bank of Australia to this hearing. I remind you that although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament.

Before I ask the Governor of the Reserve Bank of Australia to make an opening statement, I would like to acknowledge the presence of students from a number of colleges from within and around Melbourne: St Kevin's College, Alphington Grammar, University High School, Kilvington Baptist Girls Grammar and Brighton Secondary School. We have already had a suggested question from Alphington Grammar. We invite the other schools to submit a question to the chair, and one of you may be chosen to stand and ask the question. Mr Macfarlane, would you now make your opening statement before we proceed to questions.

Mr Macfarlane—Thank you very much. I would like to start by saying how pleased we all are to be back in Melbourne in these familiar surroundings. Since these half-yearly hearings started in May 1997, this is the sixth time we have appeared in Melbourne and the seventh time in Victoria. The other time was when we appeared in Warrnambool in 2002. I hope the discussions today are just as fruitful as they have been on the earlier occasions.

On Monday we released this document, which is our quarterly statement on monetary policy. You will not be surprised to hear that what I have to say today is very similar to what is contained in it. In fact, what I have to say today is very similar to a speech I gave on 14 June to the Institute of Company Directors. The past couple of months or so have been a particularly stable period and we have not felt the need to change our views much, if at all. Rather than going over all of the recent developments at this time, I will concentrate on three that I think are important.

The first, as always, is the world economy. It would be possible for someone who reads the newspapers to get the impression that the world economy is in a parlous state—rising oil prices, large US current account deficit, China on a knife edge, Japan still stagnating, the US dollar about to plunge et cetera. You will be pleased, I think, to hear that we are not of that view. In fact, we have for quite a long time been relatively optimistic about the outlook for the world economy and continue to be so. When looked at region by region there is good growth nearly everywhere. Obviously the United States is growing well, as are China, India and East Asia, but also the places we tend to overlook are doing well—for example, Latin America, the Middle East, the former Soviet Union—and even Africa has picked up and so has Japan. The only area that continues to disappoint is continental Europe, particularly the big three, Germany, France and Italy.

Oil prices—and I think they went up again last night—are a source of concern but their rise is primarily due to strong world demand, not to supply restriction as was the case in OPEC1 and OPEC2. They also do not appear to have added very much to inflation or inflationary expectations and so they have not required a specific policy response.

Much discussion recently has focused on the US current account deficit as a source of risk to the world economy. It has been argued that the United States might encounter difficulty financing its deficit and this would put downward pressure on the US dollar and upward pressure on world interest rates. In fact, the US current account deficit has been financed relatively easily and the US dollar has risen over the past year. More importantly, I think, long-term real interest rates around the world have stayed exceptionally low, which indicates a more than adequate supply of world savings rather than a shortage.

Although China has been cited as a third source of risk to global expansion, it continues to power ahead. The recent changes to its exchange rate regime, although small, will improve its prospects at the margin.

We think the most reasonable assumption is that the current world expansion, which has been going for about 3½ years, will continue for a good while yet. Most private forecasts for global economic growth for the rest of this year and for next year show above average rates, although not as strong as in 2004.

The second subject I would like to say a few words about is the interaction between developments in the housing market and household spending and saving. Recent evidence from several countries including Australia shows that during periods when house prices are rising rapidly households tend to react to this by increasing their consumption faster than their income—that is, they reduce their savings. They can do this either by reducing discretionary saving or by borrowing against the equity in their house to finance non-housing expenditure, a

process referred to as housing equity withdrawal. This process occurred in Australia particularly in 2002 and 2003. Over the past 18 months, during which Australian house prices on average have not risen, this process seems to have stopped and so consumption and borrowing have slowed noticeably. In the 18 months to the December quarter 2003—in other words, when house price rises were in full swing—retail trade rose by 10 per cent; whereas in the most recent 18 months, when house prices have been flat, retail trade has risen by 4½ per cent—in other words, its rate of growth has effectively halved.

Is this development disturbing? We think not, for several reasons. The first is that the pace of growth in domestic demand had clearly been unsustainable in 2002 and 2003. It had been about six per cent. It needed to be brought back to a more sustainable pace and this necessarily involved some slowing in consumption. Secondly, other parts of the economy are still showing good growth, particularly employment and investment. The external sector is also exerting an expansionary influence through higher demand for exports and, as you know, much higher export prices. Finally, after periods of rapid borrowing and rising interest servicing costs, a period of consolidation is welcome. The corporate sector did this in the early 1990s and is now in excellent shape; the household sector will be in a better position in the long run if it also consolidates its balance sheet.

Nevertheless, we are taking a great interest in the relationship between housing and household spending, as it has been and will probably continue to be an important influence on our economic developments. One area in which I think it has been influential is in explaining the different economic performance of the different states. We have also recently undertaken a survey of a sample of households to study the extent to which they have engaged in mortgage equity withdrawal and to see how the funds that were withdrawn were used. We will soon be reporting on the results of that survey.

The third subject I would like to cover is inflation and inflation prospects. This is particularly important given that our monetary policy is based on a regime of inflation targeting—that is, we want to ensure that the rate of inflation averages somewhere between two and three per cent. We aim for this not because inflation is all we care about but because the maintenance of low inflation is a necessary condition for having a long economic expansion in output and employment. Over the past two years, inflation in Australia has been restrained by the appreciation of the Australian dollar which took place mainly between about mid-2001 and the beginning of 2004. However, against that there have been a number of other influences which have pointed to a rise in inflation further ahead: first, as I emphasised at our last meeting, the fact that after a long expansion we are encountering some capacity constraints; second, the fact that a lot of important industrial input prices, including oil, have been rising strongly; and, third, the fact that the downward influence on prices from the exchange rate appreciation would eventually fade away.

The likely extent of the upward pressure has been difficult to assess as the signals have varied quite a bit. When I was last before you, in February, the signals were quite strong. We had received two quarters of large rises in producer prices at all three stages of production and the increase in the CPI in the fourth quarter of 2004 had exceeded everyone's expectations. There was also some evidence that the slowdown in credit had run its course and was picking up again. So, shortly after we met last time, the bank raised the cash rate by 25 basis points. Since that time we have had more reassuring news on inflation. There is also some evidence that the

monetary policy tightening itself may have had a quicker effect than normal, as we said in our May quarterly statement. I do not want to make too much of this point, but the saturation coverage of the event in the print and electronic media must have had some dampening effect on expectations, as some surveys have suggested. Of course, it would not be surprising if the household sector had become more sensitive to news about interest rates given the increased debt and debt-servicing loads that it is now carrying.

To cut a long story short, the next set of producer and consumer price inflation data that we received was more reassuring. True, it was only one quarter's information, and that was not enough for us to change our numerical forecast of inflation, but it did lead us to conclude in our May statement on monetary policy that there was no longer an upward risk to our inflation forecast. The subsequent set of data confirmed a similar picture. With two quarterly sets of more reassuring price data now behind us we were able, in our recent statement on monetary policy released last Monday, to conclude that the CPI increase will peak at three per cent in the second half of next year—and the crucial word there is 'peak'. As was widely noticed, we also refrained from making the point we have been making for the past year or so about it being 'unlikely that there will be no further rises in the course of the expansion'. That does not mean that further interest rate rises could not happen. It only means that in our present estimation there is no longer a more than 50 per cent possibility of it happening.

This is a pretty comfortable position in which to be. We are not expecting to change monetary policy in the near term, and when we look further into the future we no longer see a clear probability of it moving in one direction rather than the other. Importantly, this is also the collective view of the market, as shown by the yield curve and by economists' forecasts. Of course, individuals do not all share this view, but on average that is the collective forecast.

I do not intend to say anymore about the economy or monetary policy at this stage, but I am of course happy to answer any questions you may have on those subjects. I am also happy to answer any questions you have on the other important area of the bank's responsibility—namely, financial stability. Within that general area, the subject that has attracted the most attention recently has been the regulation of the retail payments system by the bank's Payment System Board. I know that committee members have met with the various industry participants, including members of the bank's Payments Policy Department, to discuss these issues. I will, of course, be happy to address any questions members have on that subject as well. Thank you.

CHAIR—Thank you. 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 suggest that we take questions regarding the payments system after morning tea.

Governor, thank you for your statement. Obviously the question of inflation and the forecast for it are predominant. I notice that in your statement you said that data 'did lead us to conclude in our May statement on monetary policy that there was no longer any upward risk to our inflation forecast'. Also, when you introduced the question of inflation, you said you 'want to ensure that the rate of inflation averages between two and three per cent'. In fact, when the inflation figure came out a couple of weeks ago it was 2.5 per cent, right in the middle of the target. Employment continues to improve, as we saw from the figures yesterday—over 10 million people are employed, the highest figure we have had for some 20-odd years. And the

Economist has praised you for defeating the housing bubble. It occurs to me that perhaps the economists at the Reserve Bank have talked themselves out of their jobs and perhaps it is time for some long service leave!

On a more serious note, in the August statement of monetary policy you predicted that underlying inflation is still expected to increase gradually, reaching three per cent in the second half of 2006. That is the same as previously, but now you have said the risks are balanced rather than being on the up side, and I was interested by the statement you made this morning about not saying it would be 'unlikely there would be no further rises in the course of the expansion' and there was no longer any upward risk to our inflation forecast. So, with the weakening of demand and the absence of risk to the up side, why haven't you reduced the inflation forecast? Also, it strikes me that, while the statement discusses the factors that might be taken into account in the inflation forecast, there is no documentation of how you actually make these forecasts, even though I notice that you have made some suggestions today. For example, is there a link between aggregate demand and inflation and how is that specified? If the producer price index goes up by another one per cent, what does that mean for inflation over the forecast period? I was wondering if you might comment on that in terms of where we stand at the moment.

Mr Macfarlane—That is a pretty technical question. In some senses you are asking me to outline our methodology for forecasting inflation. If I were to do that I would probably hand that over to Malcolm Edey. I just want to say a few more general things before I do that. Inflation has been under upward pressure for the reasons I mentioned. A lot of basic material prices are going up, not just here but around the world. Secondly, we are hitting various capacity constraints. In many cases in the labour market particular skills wages are going up in a quite pronounced manner. That is the underlying picture that we are working within. I think, had it not been for the very big appreciation of the Australian dollar, we would probably have seen inflation rise a good deal more than it has, because the underlying factors were pushing it up.

In 2002 and 2003 there was an additional underlying factor in that the economy was growing at an unsustainably high rate. That has now come off, and that is good news. We no longer have that particular feature pushing up inflation. We still have little bottlenecks and we are increasingly reaching the phase now where the effect of the rise in the exchange rate is starting to wear off. If you were, for example, to divide inflation into domestic influences and international influences—which we do; we show a graph of this regularly in our publication—the reason that the average was being held down was that traded goods inflation was actually negative, exports and imports were actually declining. Now they have stopped declining and they are moving back to something more normal. When that happens the rate of inflation will be some weighted average of domestically produced inflation plus international inflation. And as that process unwinds that is what gradually moves you up—what has moved us up from being, if we go back a way, sub two per cent inflation to 2½ per cent inflation. We think it is still going to go up a bit more. But we are talking about very small orders of magnitude here. In fact, for people who have been around for a long time, we think this is nirvana. Each time we sit down to do our inflation forecast the figures come out within this really quite small band. Sometimes they were a bit below two. Most of the time they are between two and three. We have had a couple of experiences even during this expansion where they have been a bit above three. It is very hard to get excited about small differences in the forecast. We think the odds are it will go up another half a point. Malcolm, do you want to add anything on the technical side?

Dr Edey—I could just make a couple of comments there. I do not think it is really true to say that we do not provide information to the public about the technical basis of the forecasts. We have published research papers over the years which set out the way we think about forecasting inflation, so people have access to that information in order to understand how we think. However, it is never going to be the case that you can just reduce inflation forecasting to a purely mechanical exercise where you feed in a bunch of numbers and you mechanically get an output. There has to be a judgment fed into that about all sorts of things to do with the strength of the economy, what we believe might happen to demand over the forecast period and so on. But I think that market economists who look at our research papers would have a good general understanding of the way that we think about inflation.

CHAIR—Governor, future market pricing implies that the financial markets assume there will be no interest rate rises this year. Is the RBA comfortable with the market believing that this tightening cycle is over, and with some changes such as the vendor tax in New South Wales being removed—which some would predict will lead to increase in pricing—do you see this as a signal to increase borrowing particularly in the housing sector?

Mr Macfarlane—I think it is quite comfortable, as I said in my introductory comments, if you are at a position where you think that there is a 50 per cent chance that the next rise might be up and a 50 per cent chance that it might be down. Remember, we are not saying everything has stopped—we are not saying that at all. I know some of the media have interpreted it as though somehow or other we have rung a bell and said, ‘The end of this tightening phase has occurred.’ We have not rung that bell. We think that there is a 50 per cent chance we may have to go up again and a 50 per cent chance we may go down again. I just want to make people aware of that. We do not know whether this tightening phase has finished. We felt six months ago that there was definitely more than a 50 per cent chance that it had not finished; now we think there is about a 50 per cent chance. We will just have to evaluate the information that comes in and decide where the next move will be. If we got some information that suggested that we had been on the optimistic side in our inflation forecasting and we got some figures that suggested it was going up more than we are now saying, then they would go back and tighten. So I think it is a big mistake for people to think that once you are not actually contemplating the next tightening there will be no other tightenings. I do not know how the New South Wales vendor tax got into that question, but maybe we can come back to that later when we are talking about state-by-state matters.

CHAIR—Your statement indicates the flattening out of the housing market, yet one sector is saying this might provide a stimulus, with the tax cuts as well. Of course, if the indications are that interest rates have been factored in—that they are not likely to rise—this might encourage people to move into an area.

Mr Macfarlane—That almost makes it sound as though the only way you can keep housing prices in Australia stable is to keep promising further interest rate increases. I do not think that is the case. My guess is that house prices are not going to pick up. I think house prices rose to such a level and the affordability is so bad and in particular sectors, particularly the investment sector, there are a lot of people who are hurting badly that I do not see house prices just poised to start moving up again quickly simply because people now know there is only a 50 per cent chance that interest rates are going to go up. That is my guess. I know the real estate industry is always looking for signs that house prices are picking up again, but I would be surprised if they did.

After the size of the boom we had, I think it is going to take a lot longer to correct than just the 18 months we have had.

CHAIR—The last time we met, you talked about the supply-side constraints. You outlined a number of issues including infrastructure, taxation, industrial relations, immigration et cetera, which received quite a lot of attention at the time. In the intervening period do you feel we have made progress in those areas? You indicated in your statement that some of the pressures have eased. Could you expand on that?

Mr Macfarlane—This is a big subject. All I will say at this point is that it is true that, at our last meeting, I spent a lot of time talking about capacity constraints—I used those words throughout; I have gone back over the transcript and that is what I was talking about—and that is a very broad subject. A lot of that was just shortages of particular skills in the labour market. A lot of it was shortages in the private sector. But the bit that attracted attention was the bit I hardly touched at all, which was the reference to deficiencies in infrastructure. For some reason that was the bit that was picked up. That became widely quoted and it set the hares running. Various things have happened since then. For example, the government had a commission to report not on infrastructure in general but on a particular aspect of infrastructure—transport infrastructure. I seem to have accidentally had quite a good effect.

We are still looking at these issues, but we do not profess to be experts on infrastructure. Some of this is very technical stuff to do with regulation and how port and rails interact and how public-private partnerships work. We do not pretend to be the experts on that. That was not the main focus of my comments. The main focus of my comments was that, in an economy which has been growing for 14 years, it would be miraculous if there were not some capacity constraints. In fact, it would be more than miraculous, it would be very sad—because it would suggest that you started off with so much excess capacity that, after 14 years, you still had excess capacity. So that was my general point. At this stage, after a long expansion, you have to be a bit more careful because there are capacity constraints around.

CHAIR—So have you been pleased with some of the initiatives taken between times?

Mr Macfarlane—Yes, I am—I am pleased that it has become a big talking point and there have been some initiatives taken.

Mr BOWEN—Governor, I would like to ask you about wage pressures. Last time we met, that was a concern for you. We saw again yesterday a considerably tight labour market. Next week we will see the June quarter of the labour price data. Is wage inflation a continuing concern for you? Specifically, when that data comes out next week, do you have a benchmark which might cause you considerable concern? For example, if wage inflation for the year were to hit 4.25 or 4.5 per cent, would that lead you to consider tightening monetary policy in the coming period?

Mr Macfarlane—The first thing to say about wages is that they have been remarkably well behaved for an economy which has been expanding for this long. None of us could have imagined as a remote possibility in the seventies or the eighties that you could have an expansion as long as this. The most recent figures we have are the wage cost index and we see it going up by 3.9 per cent. So the first thing to say is that it has been remarkably well behaved. The second

thing to say is that we do have some very modest increases—very modest—built into our forecast for inflation, and yet the forecast for inflation at the moment goes up to three and sort of flattens out at three. That is another way of saying ‘so far, so good’. But if there were to be very pronounced acceleration in inflation economy wide over the next quarter or two, yes indeed that would be precisely the sort of thing which would feed straight into an inflation forecast and would feed into the monetary policy decision making, and would be the sort of event which might bring forward further increases in interest rates.

Mr BOWEN—Turning to a different matter, lending standards, we are seeing quite a cutthroat war for market share between mortgage lenders across the country, perhaps as a result of the softening in the labour market. The first part of my question is: are you concerned about that? The second part is: do you think that the market share war reduces the need for further interest rate increases in that increases in the cash rate do not necessarily translate directly and quickly into increases in mortgage rates as lenders struggle for market share and suppress their rates more than they would have under past circumstances?

Mr Macfarlane—Can I run through that again? You are saying that essentially the discounting by the mortgage lenders is a de facto easing of monetary policy?

Mr BOWEN—In a sense, yes.

Mr Macfarlane—That is right, but it has been going on for a quite a while. We have been taking that into account in making our various decisions, including our last decision to tighten. In fact, we think that 80 per cent of the new loans taken out in the second half of last year—and it is probably the same at the moment—were at interest rates below the standard variable rate and that the average discount was about 50 basis points. So there is a huge amount of competition to retain market share going on out there, and this is common in credit cycles towards the end of a credit cycle. Everyone enjoyed it so much when lending was growing at a rapid rate—businesses were all making lots of profits; shareholders were happy; management thought they were geniuses—and they want the party to continue. The only way it can continue is by lowering credit standards or, the other term for that, underpricing risk. We think a fair bit of that is happening at the moment and we have been following it. One of the things being done is increasing the maximum allowable debt servicing ratio. I have talked about that before. That has gone up. Another thing the lenders do is when they do their calculations they put in a buffer for not just how much you can afford at the moment but how much you could afford if interest rates went up by X. That X is getting smaller in their calculations. It is something that we note, and it has an influence, in a medium-term sense, in our monetary policy setting.

It is mainly the responsibility of APRA. APRA have been doing quite a lot of work on this. But one of the problems they face is that it is possible to come up with mathematical models to show that this lending is not very risky at all, because these mathematical models are driven by the debt experience of the last five, 10, 15 or something years, which have been this extraordinarily stable period in Australian history in which there have not been any adverse shocks, so the actual figures for mortgage delinquencies and things in Australia are exceptionally low. Of course, the models assume that that will always be the case. You have to make the argument that it is not going to be like that in future; things will change. That is not a mathematical argument; that is just an argument based on history. I think it is a very persuasive argument.

Mr BOWEN—Turning to a different matter, since our last hearing it has been revealed that the bank was concerned—and sent a number of fairly strongly worded letters to the Australian Electoral Commission and to some campaign directors during the last election—about the Reserve Bank being cited as a source on various political pamphlets in relation to interest rates. I want to start off by asking you: did you consider making a public statement about that, distancing yourself and the bank from that alleged sourcing of data from the bank? If you did consider making a public statement, why didn't you?

Mr Macfarlane—Obviously, we considered various ways of responding, and in the end we responded by writing one letter seeking advice from the body which we thought was most able to give that advice, which was the Australian electoral office. As to why we did not rush out into the public arena with it, I think the answer is that it was actually a relatively small infraction. I ought to hand this over to Glenn, because he knows more about it than I do.

Mr Stevens—We had one leaflet making claims about how interest rates might be different under a different government. To our knowledge that same leaflet has been used in a number of electorates. We had one complaint from a member of the public, who said to us that this could be read as though the bank was making this particular claim. It is all to do with a missing asterisk in the text of this leaflet. The leaflet made some calculations about interest rates and there was supposed to be, I think, an asterisk saying that the source of these statistics was the RBA, and of course we are the source of statistics on interest rates. But that asterisk was missing and so where at the bottom it said, 'Source: RBA,' that might have been read as though we were making all these claims ourselves, which of course we would not.

We sought the advice of the Electoral Commission as to whether that was an illegality and whether the person putting out the leaflet could be required to stop. Their advice was that it was not an infringement of the Electoral Act and that the only thing we could do would be to write to the person authorising the leaflet and ask him to stop. We did that. We did not write to campaign directors of the Liberal Party or anyone like that. We wrote to a particular individual at a residential address and said, 'Please don't put these out anymore.' That is basically where the matter finished.

Mr BOWEN—The campaign director would have been the person who authorised the pamphlet for that particular campaign. The letter was quite strongly worded. It says:

We are most concerned that this could give the impression that the RBA has endorsed the brochure when in fact it has not. This view is reinforced by the fact that members of the public have contacted the bank seeking explanation of the claims in the brochure. Please ensure that no further distribution of the brochure occurs.

I think that for the bank it is a very strongly worded letter. What I am trying to get at is this: is there a protocol or guideline to help you determine when to make a public statement? The bank has made public statements in the past distancing itself from reporting of the bank's position on a number of occasions. The ones that come to mind are when there were reports about concessional home loans for bank staff. The bank, quite rightly and properly, issued a statement correcting the record.

Again, Governor, when you made a speech which had been misinterpreted by members of the media as an attack on government policy, you issued a statement very quickly saying that it was

not an attack on government policy. They are both right and proper things to do. But I want to put to you that, if the bank was so concerned that it wrote to the Australian Electoral Commission and this campaign director, the right and proper thing to do would be to make a public statement saying: 'The bank's name is being used in a political campaign. We do not endorse any political party and we have no views at all on which political party would better manage interest rates.' My concern is not about the past; my concern is to ensure that, if in the future any political party brings the name of the bank into a political campaign, you feel able to make a public statement distancing yourself from that.

Mr Macfarlane—You are talking about an issue of proportion. This leaflet—which was a standard leaflet, as far as I know, which was distributed in a number of electorates—quoted some historical interest rate figures with an asterisk next to those historical interest rate figures and at the bottom it said, 'Source: Reserve Bank.' We know that that is legitimate. You can do that. There is no way we could object to that.

As far as we knew, the asterisk was missing in only one electorate. If we had gone out publicly it would have been a front-page story: 'Reserve Bank attacks government for misrepresentation.' Are we going to do that because one asterisk is missing? I think the person who put the leaflet out could probably legitimately say, 'That was simply an accident; I forgot to put the asterisk in.' So we had to make a judgment on the basis of a sense of proportion. Is it worth having a huge political bun fight in the middle of an election over the fact that in one electorate the person who put the leaflet out forgot to put the asterisk in? So at the end of the day we decided: 'We won't rush out and do that. We'll ask the advice of the electoral office'—which is what we did.

Mr TURNBULL—There has been strong economic growth and strong jobs growth, except in New South Wales. New South Wales has the lowest GDP growth in Australia. Last month, as I read on the front page of the *Sydney Morning Herald*, that state lost 35,000 full-time jobs, despite what is described as a 'jobs boom' sweeping the rest of Australia. A number of bank economists have said that New South Wales may well be in a recession. With the June quarter's economic growth likely to be negative, we will have had two negative quarters. So I want to ask you: what has happened to the premier state? Why is it performing so poorly relative to the rest of Australia? To what extent have the policies of the state government contributed to this poor relative performance and what changes do you think the state government could make to restore growth in the premier state?

Mr Macfarlane—I am a resident of that state.

Mr TURNBULL—We share a concern.

Mr Macfarlane—I think that the thing that has distinguished New South Wales from the other states over the last five or 10 years has been that New South Wales had a much bigger run up in the boom period and, as a result, is suffering a bigger run down. A lot of this comes back to something which you may think is a hobbyhorse of mine: the boom and bust in house prices. There has not really been a bust but there has been a boom and then a correction in house prices. I read a lot of stuff about how New South Wales is suffering because there are not enough developers there or because there is some particular tax or another tax. People quote figures now showing that house prices in New South Wales have retreated more than elsewhere.

There is another factor, too, which I think is related to this: the population growth in New South Wales is slower than anywhere else. There is a significant net emigration from New South Wales. This really picked up in about 2001. If you look at the graphs, in the last three or four years there has been significant net emigration from New South Wales.

Mr TURNBULL—That would hardly be because of the rain. We are suffering from a drought.

Mr Macfarlane—No.

Mr TURNBULL—Why are people leaving?

Mr FITZGIBBON—There—it's not the government, it is just the weather, Malcolm!

Mr TURNBULL—Why is this happening, Governor? That is the real question.

Mr Macfarlane—I think part of the reason it is happening is that it is too expensive to live in New South Wales.

Mr TANNER—Housing costs.

Mr Macfarlane—Recently we have heard so much about house prices retreating in New South Wales, more so than in other states. It would give you the impression that somehow or other the imbalance has gone away and that Sydney is no longer so expensive relative to the rest of the country—perhaps we should talk about cities, because most of the house price data pertain to cities. It still is expensive: it is enormously more expensive than any other city in Australia. I see a lot of data on house prices, but nearly all the data you see is on the rates of increase in house prices. You see all the stuff about rates of change and you forget what the actual levels are in dollar terms. In dollar terms Sydney is still way more expensive than anywhere else in Australia. In fact, I think it is so expensive that it is in the interests of people, particularly a lot of young people, to go elsewhere to where their lifestyle is more affordable. And I think a lot of older people are cashing out, because their homes are so valuable, and moving elsewhere. I have a little graph here. I got someone to check up on the average dollar level of house prices. As always, there are four different price indices which measure house prices in dollar terms. There are another two that measure them as indices, but four measure them in dollar terms and they all tell the same story—it is Sydney and the rest. Sydney house prices are still up here; this is the rest of Australia.

Mr TURNBULL—That is relative to—

Mr Macfarlane—That is average dollar price per house in Sydney. Canberra is here, by the way—the average is actually higher in Canberra than in Melbourne. The others are much more similar to each other than they are to Sydney. We have tended to overlook this because we look at the rates of growth figures and, during the boom, we saw high figures for all states on the way up and then these figures then becoming much lower or becoming zero over the last 18 months. We look at that all the time, but we forget to look at the actual level. Sydney house prices are somewhere between 50 and 60 per cent higher than Melbourne house prices. Despite all the increases in house prices in Melbourne and Brisbane, Sydney is still extraordinarily expensive.

That is why I have to say I get a little impatient when I hear the real estate industry in New South Wales saying, 'What we've got to do is get house prices going up again; somehow or other that's going to save New South Wales.' That is Sydney's problem; it is not its solution.

Mr TURNBULL—Perhaps you can deal with what appears to be a contradiction to what you have just said. On page 36 of your statement on monetary policy there is a table which shows the percentage change in house prices in the 18 months to the December quarter 2003 and then the 18 months to the June quarter 2005. The Australia-wide average is 29 per cent to December 2003 and nil in the 18 months to June this year. Sydney actually had the second lowest growth to the December quarter 2003 and then was the only city which had negative growth to the end of the June quarter 2005. Cities which had significantly higher growth in the 18 months to 2003 are still growing strongly.

Mr Macfarlane—The answer to that is that 18 months is not a very good base period to work from.

Mr TURNBULL—It is the base period your table works from.

Mr Macfarlane—I will show you another one on the next page in a moment. It is certainly true that the Sydney housing market is probably undergoing a bigger, but not much bigger, correction than the other housing markets, as that table there shows. It says in the last 18 months Melbourne is nought, Sydney is minus seven. It would have to undergo a much bigger correction than that to get back to anywhere near the average. I do not think it is going to undergo a correction any bigger than that, but if you turn over to the next page, there is a graph on housing affordability—'Capital City House Prices to State Wages'. It is on page 38. If you look at graph B3, New South Wales is way up there on its own. Even though it has curled down at the end—that is that little correction we were looking at in the previous graph—it is still nearly 10 times average earnings in New South Wales to buy a house, whereas in Melbourne it looks like it is about seven times. Ten over seven—that is the 50 or 60 per cent I was talking about.

Mr TURNBULL—But there has been a gap for a very long time, so when did Sydney house prices get out of kilter, relatively, with the other states?

Mr Macfarlane—You are right to say that there has been a relatively constant proportional gap over that period. I have another graph here which says 'Ratio of Sydney to nationwide house prices'. From 1995 up until about 2001—

Mr FITZGIBBON—It was the year Bob Carr was elected.

Mr TURNBULL—So it started to get out of gear when Bob Carr was elected, as Joel Fitzgibbon helpfully reminded us.

Mr FITZGIBBON—People like that. People like the value of their homes going upwards.

Mr TURNBULL—So the bubble was created in 1995.

Mr Macfarlane—There is a bubble that has occurred around Australia. It occurred earlier in Sydney and by a bigger amount. This bit here, where it reaches a peak in 2001 and then comes

back, I think part of it is that net emigration from New South Wales that I was talking about. It was in about 2001 that the population growth of New South Wales slowed down to being a lot lower than the national average. The population is still growing, but it is growing considerably lower than the national average, and net emigration has picked up. I think you can tell most of the story of the boom conditions in New South Wales, which happened for a long time, and the current weak conditions, which have happened over the last three or four years, essentially through the size of the boom and bust in housing in New South Wales and the fact that the average level of house prices are just so high. They have gone up everywhere relative to wages, and so everyone has suffered this to some extent, but the level that they have reached in Sydney is just so high relative to wages. It is 60 per cent higher than anywhere else. We have tended to think that—and I have made this mistake myself until recently too—Melbourne and Sydney are very similar. In terms of growth rates, they have been very similar, but in terms of price levels, the level of house prices in Sydney is just so much higher than Melbourne. Melbourne is much more similar to Brisbane or Canberra than it is to Sydney.

Mr TURNBULL—But you do not wish to respond to my question about the impact of state government policies of economic management on house prices in New South Wales and the economic recession in New South Wales? Everyone else is commenting on it.

Mr Macfarlane—I know. To my knowledge, the main commentary has been over the last 18 months, and the main topic has been developers of real estate saying, ‘Wasn’t it a terrible thing that the vendor tax was put on?’ What I am saying is: I do not think that was a particularly large part of the story at all. The big part of the story is shown by those various graphs I have just shown you. I wish I had been able to go through that stuff a year earlier. We are learning all the time as we go through. The difference in the level of house prices between Sydney and the rest of the country is something that has been forgotten, because we were all looking at the wrong thing. We were looking at the rate of change of house prices and forgot to look at the level.

CHAIR—Thanks very much. I think we probably need a change of pace.

Ms GRIERSON—Governor, in your statement you say that oil price increases are a source of concern—and there have been a lot of comments about that—but at this stage you say there is no supply restriction and, therefore, no inflationary effect, so you are not required to provide a policy response. What price and supply factors do you predict would make a policy response necessary and what policy responses would be available?

Mr Macfarlane—When I say a policy response has not occurred, I am talking about world wide. Obviously, in big countries like Japan and the euro areas, they have done nothing—interest rates have not gone up at all. In the US they have, but they have gone up for other reasons. My comment about there not having been a policy response is really a worldwide observation. In Australia it has actually been, in some ways, even easier for us, because the period of maximum increase in world oil prices, which are always quoted in US dollars, was a period when our exchange rate went up so much. That has cushioned the effect in Australia. In fact, I am somewhat surprised that it is not as big a public issue as it has been on some earlier occasions when oil prices went up. I think that is the reason. Our oil prices were going up when world oil prices were steady. The Australian dollar was going down through 1999, 2000 and into the middle of 2001. We got a lot of our increase in oil prices way back then. Then, when the world’s oil prices shot up, ours were cushioned by the rising Australian dollar. It has actually been a very

gradual process in Australia; it has not been a shock that has hit people and made the headlines in the way that it did on some earlier occasions.

Mechanically, in Australia, a 10 per cent rise in the price of petrol, as petrol is about four per cent of people's consumption basket, reduces their spending capacity by 0.4 per cent. That has not been a big deal, really, in that petrol prices have gone from, say, 90c to $1.00 to $1.10. It is not insignificant, but in this sort of range it has not been that important. At some point, it clearly does become important, and then the interesting issue is the policy response. It is going to be, simultaneously, inflationary and it is also going to reduce people's income. There was always this quandary: how do you respond? I think that now it is not as inflationary as it used to be, because the competitive environment is so great people cannot just pass the cost increase through into prices. I think that is another reason why there has not been the traditional response to a lift in prices by tightening monetary policy. I think there is a feeling that now, in a much more competitive world, more of it is going to come through not in inflation but just as a reduction in purchasing power—or, for businesses, a squeeze on profits.

Ms GRIERSON—Your comments on doing some research into equity loans on mortgages is particularly interesting given the discussion we have had on housing and property costs. Have you any early indications of what people were using the loans for or the distribution between lifestyle expenditure and investment? Will your data break it down state by state as well?

Mr Macfarlane—The answer to the second part of the question is that it will not break it down state by state. The answer to the first part is that, in a sense, there are two types of mortgage equity withdrawal. There is the type that we tend to think of—can I say—as bad, which is people simply increasing the borrowing on their existing house and then going out and buying a boat or a car or an overseas holiday; in other words, it all goes straight into consumption. There is another type of equity withdrawal which I do not think we would think of as bad—for example, an older couple who own their house outright selling it and buying a cheaper house. They have liberated a whole lot of equity which they might put into financial assets—an allocated pension or something like that. That is also household equity withdrawal. That is something which most people would regard as quite a sensible thing. This is what we want to get to the bottom of. How much of it is this stuff that is just pumping up consumption and how much of it is financially responsible provision for the future? Glenn, you have been closer to this study than I have. Can you give a preliminary report?

Mr Stevens—It is too early to give a full account of this because we are still going through the dataset and it is very complex. The other important thing to keep in mind is that probably a lot of the equity which is liberated from the housing stock does not go into consumption at all; it goes into some other form of asset. If I am downsizing my house, for example, because I have retired or my kids have moved away or whatever and I liberate a lot of equity by selling a larger house and going to a smaller dwelling, more than likely some of that money will be consumed but the bulk of it quite possibly will end up in some other form of asset, so what I have in effect done is exchange one kind of asset for another.

What that means is that the full extent of the liberated equity from the dwelling stock may not be all that close a guide to the impact on consumption. Indeed, on some aggregate data that we have it looks as though the housing sector in total was extracting eight or 10 per cent of a year's worth of income from the housing stock at one point. That is a very big amount. If that was all

going into consumption it would be a huge boom. When it stopped happening, as it seems to have done, we would go into recession—if that was all flowing in and out of consumption. Clearly that has not happened and I think the reason is that a lot of that money ends up in other forms of assets.

It is a very complex picture. Some of the extracted equity does seem to have gone into consumption. We think that added a little to consumption for a year or two and has stopped adding to it in the past year or so. That is part of the story, as Ian was saying earlier in the introductory comments, as to why consumption has had the pattern it has had, but there is a lot more going on than just that. It is also going into other asset markers. We should be able to publish some details on this before much longer, I think, but at the moment we are still extracting what is a very complex dataset.

Ms GRIERSON—At the last hearing I was interested in the normalising of regional data. With disparity in the economy these can have such different impacts on people. The disparity which is now so significant and unprecedented is the disparity between state economies. Do you see that impacting on your methodology at all in terms of the data you gather and the decisions you have to make from that?

Mr Macfarlane—I think it is true to say that we spend more time looking at it than we used to. Our regional—we call them 'regional' but they are really state offices—are very active and they speak to a lot of people. This information gets fed into our assessment and our forecast. I am not sure that you can pinpoint in a particular way how it affects a monetary policy decision, although I have to say that for a long time, particularly during periods when we were putting interest rates up, we were often criticised for only looking at New South Wales, or being excessively influenced by Sydney. I am very pleased that over the last three years, when New South Wales has been the most sluggish state—and Sydney is the one that is having the biggest property correction—and we are still putting interest rates up, no-one can accuse us of only looking at New South Wales or Sydney.

Ms GRIERSON—Thank you, Governor.

Mr CIOBO—Governor, I would like to turn your mind to, in particular, the RBA's function with respect to public comments that you make and the manner in which that feeds into some of the factors you take into account in determining monetary policy. You possibly would recall that, when an announcement was made in April with regard to interest rates, you came under some criticism. An article from the *Sydney Morning Herald* said:

> When nothing happened on Wednesday, there was surprise, puzzlement, suspicion, even anger. The shadow treasurer ... said: "They barked a lot but they only bit once, so it's very hard for them to be taken seriously now. You don't go barking for months like they did and then just give a nibble."

My question to you is in two parts. Firstly, did the Reserve Bank get it wrong? Should you have increased interest rates back in April by 25 basis points, as the shadow Treasurer would have liked? Secondly, I would like your comment on the appropriateness of your making public comments with respect to, as I said, influencing factors which subsequently feed into the policy settings that you make with respect to monetary policy.

Mr Macfarlane—I am not sure that the shadow Treasurer was saying that we should have increased interest rates. Maybe we should consult him on that. I think he is referring to the fact that interest rates went up in March and then in April there was a division in opinion between those who thought they would go up again in April and those who thought they would not. It was not at all surprising that there was division of opinion, because it was a rather difficult decision to make. It was a very close-run decision. It seems to me that, when things are very close run and you are not sure whether you are going to or whether you are not, it is entirely plausible that the community will also be equally divided between those who think you should and those who think you should not. The fact is, when you come down one way, the people who were betting their money the other way are going to feel aggrieved. And they were. A lot of them felt that they had lost money, or their company or their bank had lost money, and they were very unhappy about that and they had to find someone to blame. We were the obvious ones to blame.

What could you do to avoid that situation? When you think about it, there is really nothing you could do to avoid that situation. If it really is a close-run thing, it is inevitable that opinions will be equally divided. I think some of the commentary after that almost got to the point of saying: 'You shouldn't have allowed this to happen. You should not have allowed us to make a mistake. You should have told us in advance what you were going to do.' That is not the way you run monetary policy. They have to realise that there will always be periods of uncertainty. Some people will get it right; some people will get it wrong. We tell you what we can tell you but, when we are very uncertain, we can hardly put out a press release saying, 'We are very uncertain.' This is just the way the world works. Sometimes there are going to be months when it is a very close-run thing, and some people are going to get it right and some people are going to get it wrong, and there is nothing you can do about that.

Mr CIOBO—I think you are most charitable, because I would interpret 'they should have bitten rather than nibbled' as showing a very strong, to use the parlance, bias towards increasing the rate further. But let me move on to something else. You commented on world oil prices and the fact that they are at record highs. We are seeing subsequent increases in petrol prices at the pump and an impact on inflation. Could you do a little bit of crystal ball gazing: if we continued to see increases in prices, which subsequently led to an above expectation result in inflation, would that be something that the RBA would have concerns about and would be likely to react to?

Mr Macfarlane—I suppose this is all a function of just how far it goes but—

Mr CIOBO—I should clarify: assuming it moves beyond your target band.

Mr Macfarlane—We look at several measures of inflation. The main one, obviously, is the headline inflation, which includes the effect of the oil prices, and our long-run average is set in terms of that. Over shorter periods—over a period of a year or 18 months—if, for example, the only reason inflation was going up to an unsatisfactory level was because of a rise in oil prices and the rest of the consumer price index was behaving itself, then that would enter into our thinking on it. That would be an argument for probably not mechanically reacting to the increase in the CPI caused by oil prices.

The other thing that you have got to remember is that it is only when oil prices are going up that it affects the CPI. If they reach a high level and stay there, then, after a quarter or two, that

will no longer be having an effect on the rate of change of the price level or, in other words, on inflation. So we do not mechanically just look at inflation and ignore the parts. We definitely do decompose it into its two parts and that does affect our decision.

Mr CIOBO—On page 25 of your *Statement on monetary policy* from August, you say:

Growth in household consumption may persist at more moderate rates than seen over recent years, but it should be supported by favourable labour market conditions and consumer sentiment, as well as the boost to incomes from recent Budget initiatives.

Tying that comment with questions from my colleague Mr Bowen with regard to wages inflation, do you see the impact from recent tax cuts as being an appropriately timed measure with respect to where we are in the economic cycle? Do you see any impact flowing from that?

Mr Macfarlane—This question is usually asked the other way. It is usually: has the irresponsibly expansionary fiscal policy led to you wanting to run tighter monetary policy? You have turned it on its head: has the enlightened fiscal policy that has been introduced allowed you to run easier monetary policy? I think that I have to give the same answer to the question, whichever side it comes from. Fiscal policy has not been a significant influence on monetary policy at all in Australia for the last six or seven years. Whilst ever there are not big swings in the fiscal position in either direction it has not been a factor that we have really had to take into account in our monetary policy, and that is the way I would like it to continue to be.

Mr CIOBO—I will draw the conclusion that, with no upward bias on interest rates, it has not been inflationary. Finally, I have a question with regard to mortgage equity withdrawal, and I take into account comments that you and Mr Stevens recently made. I am someone who experiences it first hand on the Gold Coast with the shift that we see as people downsize. Do you see any long-term consequences from that? Is it a move where you have, for example, net emigration from New South Wales? Is it a trend that we are seeing Australia-wide that is quite sustainable? Do you expect the data to reflect that? Or have you got underlying concerns and that is what has prompted your close investigation of this?

Mr Macfarlane—Our close investigation of mortgage equity withdrawal is, as Glenn Stevens said, because, on the surface of it, the material we initially published was quite alarming and we wanted to look into it to reassure ourselves that it was not alarming. When we say that we are doing some research, we have actually had to hire a private survey firm and help them construct a survey of 4½ thousand households. It is quite a big exercise and we have been working on it for the best part of a year. So our main interest was just to get underneath that to see how much of it was simply changing from one asset to another and how much of it was changing out of an asset into consumption.

On the issue of interstate migration, I have not looked into it enough to feel that I can say anything definitive other than to observe that, on the one hand, the states that have received the immigration—principally Queensland—are very proud of the fact that their population is building up so quickly; on the other hand there is a contrary view that a lot of the immigrants are people who have passed their working life span and are going to be a strain on the provision of community infrastructure. I do not know enough about it to know whether it is a good thing—if it is people just going to where the growth is—or whether some of it is the opposite: people

finding that it was too expensive to live where they came from so they will spend their later years in Queensland. I do not know enough about it, but one could construct a case either way—where the state that is receiving the immigrants should be very happy about it or slightly disturbed.

Mr TANNER—First, for the record, the shadow Treasurer was not advocating an increase in interest rates. I have two related questions, Governor. The first is on the question of the trend in foreign debt. I noted that on page 43 of the statement you point out that there is a 14 per cent increase in the year to March of net foreign liabilities, taking that figure up to 65 per cent of GDP, and that mainly this is driven by an increase in net foreign debt. The language you use in describing this is pretty bland and benign. Does that mean you regard the trend as not a matter of great concern and, if so, is this because you expect it to moderate in due course, reflecting a substantial and sustained improvement in the current account—and by definition, perhaps, a significant decline in the value of the dollar? That is question No. 1.

Mr Macfarlane—None of us knows what the right level of external debt to GDP is. We went through the eighties where people thought the world would come to an end if it got above 40 per cent. It did not come to an end, so it has made us all very modest about our ability to judge whether there is some critical level there or not.

On the balance of payments, yes, we think that the widening of the current account deficit reached its peak in the March quarter of 2005. The figures that have come in so far on the June quarter have been an improvement from about three different sources. The slowing in domestic demand has got to help—imports were just going ahead at an extraordinary rate. That has slowed a bit. Obviously the big lift in the terms of trade has been very beneficial. It basically took $1 billion off the monthly trade deficit as soon as it fed through in April, May and June. And we think that there is finally starting to be some evidence that export volumes are picking up—we have now had three quarters in a row where the export volumes have picked up. The current account deficit, which had got up to a bit over seven per cent of GDP, is probably about a percentage point lower now and the odds are that it will come down a bit after that.

Mr TANNER—My question was really about the trend rather than the absolute level of foreign debt. I take your point about past experience. My concern is the trend.

Mr Macfarlane—I think the arithmetic is that, if the current account deficit stays within any particular range, then the ratio of debt to GDP flattens off at that point. It does not keep going up just because you are having a current account deficit.

Mr TANNER—The second question relates to the outlook for export manufacturing. I have a couple of preliminary observations. Our productivity performance across all sectors has been relatively ordinary in the last few years. We dropped below the OECD average growth rates in 2002 and have stayed there, we have been declining relative to the US since 1998 and of course the gap in productivity between Australian manufacturing and much of the developed world or leading manufacturing nations has historically been pretty substantial and still remains that way. For about the past five years the pattern in manufacturing exports has been stagnant at best. The AiG talks about the lost $6 billion in manufacturing export returns—that is possibly a reasonably flamboyant way of describing it. Nonetheless there is an issue there that I think is of considerable concern, particularly tied with the fact that in spite of record profit share and

extraordinarily healthy corporate balance sheets, perhaps not so in some manufacturing sectors but generally, R&D has only just returned to the level, as a percentage of GDP, that it was at 10 years ago after a period of prolonged decline.

Can you give me your view? I notice there are several rather elliptical comments about manufacturing in the statement, referring perhaps to recent slight improvements. What do you see as the medium-term outlook for export manufacturing, given that we had a period of sustained growth up to about the turn of the century—which was clearly very necessary, relative to where Australian manufacturing had been historically—and it has very much flattened out and there are a lot of pressures in the sector now?

Mr Macfarlane—Malcolm, you have looked at manufacturing output and manufacturing exports. Perhaps you could say a few words on this.

Dr Edey—It is true that the 1990s was quite an unusual period for expansion of manufactured exports. Depending on the way you define the sector, exports during that decade were rising at about 10 per cent per annum. That has basically flattened off so far this decade. There are a number of reasons for that; some of which are temporary and some of which are more permanent. The temporary factor in the early part of the decade was the global recession. More recently the strength of the exchange rate has put a cap on manufactured exports to some extent. Both of those factors should be now less powerful because the world economy is growing strongly and the exchange rate has been more stable recently, or come off its peak. In the last year or so manufactured exports have done better. In nominal terms they are up by about seven or eight per cent. I am not sure of the exact figure.

Mr TANNER—Is that in dollars or volume?

Dr Edey—That is in dollar terms. They are doing a bit better, but I think it is unlikely in the medium term that we will repeat the experience of the 1990s, because with trade liberalisation there was a one-off opening up of the economy which expanded trade in both directions, and the manufacturing sector was a particular beneficiary of that. You will not see that effect happening again in the current decade. I would expect to see a return to more moderate growth from here on.

Mr McARTHUR—I will return to the problem of the world oil price. You have been fairly benign in your comments as to its effect on Australia. The oil price is starting to affect farmers, miners, other manufacturers and of course the transport sector. Qantas have suggested a fuel surcharge and expressed concern about $600 million being added to their bottom line. Can you give us an indication of what is different now, with these record world oil prices, compared to the 1970s oil shock? What do you think will be the impact of the oil prices on the world economy, as well as on Australia?

Mr Macfarlane—There are two differences from OPEC1 and OPEC2, which I remember very well. Firstly, the increase in oil prices proportionally was much greater than it has been this time. Secondly, the reason oil prices have gone up this time is because world demand is so strong. In OPEC1 and OPEC2 we woke up one morning and OPEC said that the price of oil had gone up by a factor of four and that they were going to restrain supply to make sure the price stuck. It was a clear withdrawal of supply that was forcing price up. In this case they are

pumping as much as they can. The world economy is just growing so fast—particularly with China, India and other heavy users of oil coming on-stream—that it has forced the price up.

The second thing is that some industries get hit very clearly—classically airlines all around the world get hit very severely by an increase in the price of oil. Looking at Australia as a whole country, rather than at individual sectors, we can see that we benefit because we are a net energy exporter. There is enough similarity between oil prices and the prices of other hydrocarbons like coal and gas that when the dust settles we gain more in income than we pay out in extra expenditure because of the higher price of oil. For the country as a whole, the oil price shock is not directly harmful. It is only harmful in so much as it might cause the rest of the world to slow down, but it is not harmful to our industries. If you add up all the industries, the ones that benefit benefit by more than the ones that lose.

Mr McARTHUR—Could I go to your opening remarks about the slow economic growth in Europe, particularly in Germany, France and Italy: what do you think are the factors contributing to that slower growth compared to other Western economies?

Mr Macfarlane—I think the biggest single explanation is that they have very old-fashioned, heavily overregulated economies. Some people say that monetary policy should be eased, but interest rates are only two per cent so there is not a lot of room there. I think it is intrinsic to the economic model that they have which has extremely heavy regulation of goods, labour and capital markets. They just do not have the flexibility that, say, some of the newer European countries like Spain have, or the so-called Anglosphere that we are part of, where we have much more flexible economies.

Mr McARTHUR—Would you outline the relationship between economic regulation and the labour market regulation? Would you give us a view on those two aspects?

Mr Macfarlane—One of the forms of heavy regulation in Europe is labour market regulation. It is extraordinarily heavy labour market regulation, most of which has the effect—as a lot of regulations do—of protecting the insiders at the expense of the outsiders. So the people in the jobs are very heavily protected, while people trying to get in find it very difficult. That is why they are all running 10 per cent unemployment.

Mr McARTHUR—Thank you.

Mr FITZGIBBON—Governor, I was a bit surprised by Mr Ciobo's initial question because I thought you had adequately answered it in your comments on inflation on page 4 of your opening statement today, which I think it is fair to interpret as your defence against the Treasurer's comment that the government got it right in March and, by implication, you got it wrong. Given the nature of your defence, can we now conclude that you still believe that you got it right? And, if your subtle signals to the market and to the wider community had not been successful, would it have changed your inflation forecast?

Mr Macfarlane—I think I have dealt with some of this already. There are people who like to say, 'Oh, well; your last increase was a mistake,' and my answer is: 'How do you know it's the last? We haven't said it's the last. In fact, there is a 50 per cent chance it won't be the last.' I cannot remember the rest of your question.

Mr FITZGIBBON—I think that will do, thank you. How critical to your predictions on inflation is this convention that the Australian dollar will basically remain unchanged? For example, if the Australian dollar were to depreciate, say, 10 per cent against the weighted index, what implications is that likely to have for monetary policy? And can you give us a prediction about where you think the Australian dollar is headed in the next little while?

Mr Macfarlane—I can answer your last question first: no, I cannot. The other question is a very interesting one, though, because how do you run an inflation-targeting model if a lot of the movements in inflation are going to be caused by movements in your exchange rate? I think the answer is that, more and more, we look behind the movement in the exchange rate and look at underlying domestic costs and prices. A movement in the exchange rate can trigger some of those, but it also might not.

During the period when we have been raising interest rates, which really started 2½ years ago, and particularly early in the period, measured inflation was quite low because the exchange rate shot up. Someone could literally come along and say, 'Inflation is below two per cent; you should be easing.' We used the argument that you had to look beyond just the straight figures for inflation and you had look at what the underlying movements in domestic costs and prices are, because that rise in the exchange rate is going to stop at some point. And even if it does not go down, if it merely stops going up, then all the downward pressure that it has been exerting on inflation will melt away and you will be left with whatever the underlying rates of increase in domestic costs and prices are. So the answer is yes, we look at the exchange rate. If you ran a model where every time inflation got low, and it was only low because of the exchange rate and that caused you to ease, then if you followed this through you would end up with a very destabilised monetary policy and a very destabilised economy. So you have to, in a sense, look through the exchange rate effects.

Mr FITZGIBBON—You mentioned your speech of 14 June to the Institute of Company Directors. I think on that evening you said that if you followed the traditional relationship between the terms of trade and the $A, the $A should now be higher. I think you reflected that this might be due to some concern about the current account. Could you expand on those comments.

Mr Macfarlane—I am not sure I know anymore about how to explain them. Graph 59, on page 58, shows that the previously close relationship between the terms of trade and the real trade weighted index has changed over the last two years. I think probably quite helpfully for Australia our exchange rate has not gone up to the extent that it would have if the past relationship between it and the terms of trade still held. So in some sense that has been a stroke of good luck—and you actually do not spend much time examining your strokes of good luck. You only ever spend time examining things when you think you have been unlucky or you are looking for something else to blame. So we do not have a clear explanation for why it went up as much as that. One explanation is that people perhaps thought that the rise in the terms of trade was very temporary, that it was just going to be a short-lived spike and it was going to come down again. A lot of people have been thinking that over the last couple of years, whereas in fact it has not—it has continued to go up. It may go down sometime in the near future—we do not know. But even if it does there has been a very big increase in real incomes in Australia as a result of it going up so high and staying as high as it has for so long.

Mr SOMLYAY—Would there be any implications for monetary policy from the sale of Telstra which is worth about $30 billion? That would be quite a major withdrawal of money otherwise available for current consumption.

Mr Macfarlane—There would be a very big impact if the proceeds from the sale of Telstra were spent or handed back to the private sector immediately in tax cuts to be spent. There would be a massive fiscal expansion. That is the reason the government has other plans for it. Thirty billion dollars is about four per cent of GDP. If that was immediately spent or handed back, that would be the biggest fiscal expansion we have ever had, and at entirely the wrong time to have one. So it would potentially have a very big impact. But if, as I believe it is meant to, it is going to the Future Fund then there will not be any particular monetary impact from that.

Mr SOMLYAY—But it would represent a withdrawal of money available for current consumption, wouldn't it? If people use their savings to buy Telstra shares instead of spending them, what does that do to demand?

Mr Macfarlane—A lot of Telstra shares are going to be bought from overseas, I should think; they will not all be bought from here.

Mr Stevens—They are not going to stop consuming to fund the purchase of Telstra shares. I would think they are going to use other assets to fund that. To a first approximation, the impact on consumption is going to be nothing, I would guess.

Mr SOMLYAY—It is a transfer of savings.

Mr Stevens—Yes.

Proceedings suspended from 11.34 am to 11.53 am

CHAIR—Ladies and gentlemen, let us proceed. The committee will receive the two graphs from the RBA as exhibits. Is it the wish of the committee that the graphs be received as evidence and authorised for publication? There being no objection, it is so ordered.

The graphs read as follows—

At the time of publication the graphs were not available.

CHAIR—I am sure *Domain* in the *Sydney Morning Herald* will look forward to publishing the capital city house prices graphs on the front page. We will leave questions from the students until the end. I would appreciate it if you did not sit on your merits—can we have a couple more questions? The ones we have here are of varying quality, so I would appreciate a couple more being sent through to us.

We will move on to the payments issue now and then, if there is time, we will move back to the economy generally. There may be enough in terms of the payments. Last time we did not really have enough time to talk about the payments issue. We had a special roundtable session with Dr Phillip Lowe in which we spoke to various retail groups, American Express, Diners Card, Visa and some of the larger retailers on a national basis. Governor, I want to raise the basis

of the concern about the recent changes, which of course were the first anywhere around the world in terms of credit charges, where the charges were prescribed and the interchange fees between the banks had an effect whereby the rewards programs for the cards were significantly reduced and charges for credit cards were put up. As a result of that there were claims by the retail sector that this had resulted in a shift to some of the charge cards because it was only a three-party system instead of a four-party system and therefore they were not subject to this interchange fee, and they were able to be the beneficiaries of a shift from the credit cards which were prescribed into the charge cards, particularly Amex. They were able to charge a higher merchant fee and offer higher rewards programs.

Of course, this was partly questioned by Dr Lowe in terms of the figures that he had available. Nevertheless, it seemed evident to us that there was a move by some of the banks—Westpac and the NAB in their arrangements with Amex and ANZ in its arrangement with Diners Club card—to migrate cardholders who held the traditional Visa charge card that was subject to the restrictions that applied to rewards programs into new schemes where they avoided these restrictions and were able to charge the higher fees. That seems to have been reasonable successful.

The question at the end of the day is: have we achieved something significant in terms of these changes, because there is no evidence in terms of consumer price changes that there has been an improvement as far as the consumer is concerned? We have not seen a lowering of prices. We have seen a shift out of the traditional credit cards into the charge cards and there has been a mechanism of encouraging people to migrate in terms of the higher charge fees that apply in those types of cards. That was the central theme of it, so please feel free, colleagues, to jump in and ask specific question related to that. That was the overall scenario that was painted for us. Of the various people we spoke to, no-one seemed to be terribly content with the situation. Of course we had the complication of the proposals in relation to EFTPOS, but could we start off with general comments about the claim that the consumer at the bottom line has not benefited. The reduction in costs that it was thought would flow through has really just resulted in a shift in the cards being used.

Mr Macfarlane—There are at least five separate questions there. I will start with the one about prices not having gone down. I do not know who said that, but whoever it was obviously has not done any measurement.

CHAIR—I think it was a result of the CPI in terms of retail pricing. I think we asked Mr Lowe to provide us evidence of a lowering of prices and, as I recall, he said that there was not any evidence to date that there had been a lowering.

Mr Macfarlane—That is very different from the claim that prices have not gone down. I think the argument is that the benefit to the users of the payment system is $580 million, which they have clearly received. That $580 million is a lot of money but it is actually between 0.1 and 0.2 of one per cent of consumer expenditure. The truth of the matter is that with the consumer price index going up by 2½ per cent per annum it is just not possible to identify something that is as small as 0.1—that is, one-twenty fifth of it—or 0.2, which would be one-twelfth and a half of it. You just cannot identify something as small as that. That is all we can say. We cannot prove to you that prices have gone down, because the sum of money, $580 million, is such a small part of consumer expenditure that no statistical measure will be able to pick it up.

I have to say that all my life I have been told by businesses, 'You'd better not put a business cost up because it will have to go through to prices,' or every time they say, 'Cut this business cost because prices will be lower.' Cost and prices are very strongly related, particularly in competitive industries, and retailing is a competitive industry. So I find it inconceivable that that particular change in costs did not have an effect on prices. Unfortunately, it is so small that we cannot prove it, but it would be the first occasion ever where a reduction in costs to a competitive industry did not involve some reduction in prices. So I do not believe for a minute that prices have not gone down. If they have not gone down, that particular set of businesses must be very different from all the other businesses I have ever encountered in my life. So I think you should just assume they have gone down. It is just that we have not got statistical measurements that are fine enough to be able to pick it up, because it is a small amount.

The second point is this thing that consumers have not benefited. Let us go back to the whole point of reform of the payment system. The whole point of the reform of the payment system was to make the users of the payment system better off, because we believed that the providers of payment services were charging far too high a price, it was far too profitable for them and there were not enough competitive forces to push that down. Who are the users of the payment system? The users of the payment system are consumers—and within consumers we include cardholders and other consumers: consumers who buy using other purchasing methods—and also merchants. So we have to look at the totality. We have to look at who is going to benefit, including everyone, not just cardholders. It turns out that a lot of people make this sort of slip of thinking that 'consumers' means 'cardholders'. Even within cardholders there are two types of cardholders. There are those who are simply transactors and those who actually borrow against their credit card. So there is a whole multitude of different types of consumers plus all the merchants. What we are saying is that in aggregate those people are $580 million better off than they were before our reform.

One particular group, the cardholders, are the ones who are complaining. These have actually suffered a reduction in the subsidy that they were receiving. Because they have suffered a reduction in the subsidy, they are not very happy about that. But these were the people who were actually getting something for nothing. These were the people who were able to use someone else's credit and not pay for it and, in fact, receive some various points and inducements. That subsidy has been reduced. We make no apology for that whatsoever, because you cannot make everyone better off even if you make the totality better off. We have made the totality better off, but one group, who were the beneficiaries of a big subsidy at the expense of others, have had that subsidy reduced. They are having to pay for services that are being provided to them. Their fees for receiving a card have gone up, but that card provides a very significant service and it is very expensive to provide all the accounting and everything that goes on behind it. Now some people are having to pay for something which they were formerly getting for what appeared to them to be free, but it was being charged to someone else and now they are having to pay some of it themselves. So that was actually one of the many purposes of payment system reform.

There were three questions about the relationship between the four-party schemes and the charge card schemes. The first thing we want to say is that we want it all to hang out; we want everyone to know what the market shares are. At the moment the players are very reluctant to disclose their market share, but at the same time as being reluctant to disclose their market share they have made a lot of allegations about what has happened to the market share that they will not disclose. Our response to this is: disclose the market share; let everyone see what has

happened. We have managed to get agreement on limited disclosure. We will be able to disclose in our next monthly bulletin the split-up between the four-party scheme—that is, Visa and MasterCard—and the three-party schemes, which are Amex and Diners.

Mr FITZGIBBON—Including historical data for the last few years?

Mr Macfarlane—It will show that there has been a small shift towards three-party schemes—a shift whereby their market share has gone up from, very roughly, 10½ per cent to 12 per cent, and that occurred in the first half of last year.

CHAIR—As we understand it, that does not apply to this new form of hybrid cards, which are the bank sponsored Amex and Diners cards.

Dr Lowe—The change that the governor just spoke about includes those cards. It includes all American Express cards.

Mr CIOBO—My understanding was that where you had a cobranded credit card, the market share would be reflected in the bank's market share rather than Diners Club or Amex.

Dr Lowe—We have separate data on those bank-issued cards which would be included in the share.

Mr CIOBO—So even for the cobranded, you are saying that it only represents from 10½ to 12 per cent.

Mr Macfarlane—The banks may do that but the stuff that we are going to publish will—

CHAIR—Can I clarify that. Is that different advice from the advice we had last week?

Dr Lowe—No, it is the same. Last week we did not talk about the specific numbers but we did talk about a very small change in the market share.

CHAIR—I have just checked with my colleagues and we understood that last week your response was that the cobranded cards were not included in those figures.

Dr Lowe—We have not yet published any figures but the figures that we publish will be all American Express and Diners Club cards.

CHAIR—For the cobranded cards as well?

Dr Lowe—Yes.

Mr Macfarlane—The other thing I want to mention is that cobranding happens everywhere in the world. It is not as though it was invented here because we made these changes. There are cobranded Amex and Diners Club cards in America and Europe. It is not as though it happened only because of the reforms of the Australian payment system. We want the information out there, and that is what the information will show: an increase of somewhere between 1½ and two per cent and that it happened at the point when the cobranded ones came on board, which I think

is a very small change. It is nowhere near as big as you would think if you had read the newspapers and heard what the banks were saying.

I might leave it at that point other than to say that it is not as though we have done nothing to American Express and Diners. We have got them to agree to at least three changes: they now publish what their merchant service fees are; they have agreed to allow merchants to charge—in other words, to pass on—the fee if the merchant so chooses; and they have also altered their agreement so that if you come in with the charge card which is expensive, the merchant can say, ‘I would much prefer it if you paid with the credit card,’ which is half the price. That used to be ruled out in the Amex agreements. That is now permissible. So a merchant can either charge you for it or he can say, ‘Please use another card.’ That was not possible before. The whole point of this exercise is to empower the merchants—give them some bargaining chips to use against both the credit card providers or the charge card providers.

Mr CIOBO—I have some ongoing concerns about the intervention in the payment system. You speak of $580 million in savings. I am struggling with the question of whether there is $580 million in net savings or $580 million in terms of a transfer of savings. Could you please comment on that? I am interested in whether or not you can specify that there is a net benefit of $580 million. You have just stated that credit card fees have increased as a consequence of annual fees and the winding back of cross-subsidies with frequent flyers schemes and those types of things. In light of this, is it accurate to say there is a net saving of that amount?

Mr Macfarlane—You are right: the net saving is smaller than that. But, even if there were no net saving, even if it was all recovered by direct charging—in other words, if the subsidy were taken off and replaced by user pays—we would still regard that as a success because people would be charged for using the expensive thing rather than subsidised to use the expensive thing. We have some actual numbers on the net saving.

Dr Lowe—The saving over the last year for merchants was $580 million and the increased charges levied on households by banks over the last year was $180 million.

Mr CIOBO—But you cannot quantify the qualitative downsizing, can you?

Mr Macfarlane—What do you mean?

Mr CIOBO—The winding back of, for example, the various schemes we use to entice consumers. You cannot quantify the value of those qualitative aspects, can you?

Dr Lowe—In general terms, I cannot give you a number, but I can tell you that the cutback we have seen in the reward schemes is much less than $180 million.

CHAIR—I have heard various figures on how much it is worth each year to, for example, Qantas, in terms of frequent flier programs. How much that is worth must be quantifiable in some way.

Dr Lowe—I do not have any figures on the value of reward points for Qantas. It used to be the case that reward points were worth around 0.8 per cent of the amount that an individual

spent. Under most of the bank schemes, that number is now around 0.6 per cent. The reward points have been cut, for people who actually redeem them, by about 0.2 per cent.

Mr Macfarlane—I am surprised to hear that you are so worried about protecting a cross-subsidy. The questioning almost implies that we are taking something away and putting on a charge. What we are doing is reducing a cross-subsidy. But people never got that for nothing. They got it because it was levied on the merchants, who then passed it on, and every ordinary consumer had to pay for it. The ordinary consumers were paying for reward points for the subset of consumers who had these credit cards. All we are doing is reducing that cross-subsidy.

Mr CIOBO—Whilst I think it is admirable to look at reducing that cross-subsidy, with this intervention I believe you have removed the power of providers in the marketplace to determine the cost mix that they would like in their products. To me, the underlying issue in all this is transparency. As a result of this reduction of overall revenue, if a new entrant to the marketplace seeks not to provide a cross-subsidy and to scale back its product—and we have seen this with some new entrants, which I think is fortuitously coincidental as a result of this intervention—it is now so much less likely for there to be a scheme that is going to be attractive in enticing new consumers. Anecdotally, at least, the evidence this committee has received is that consumers are choosing to engage in that cross-subsidy type product because they like the fact that they can have reward schemes and not pay for them. As you have said, no-one gets something for nothing. It is attractive for people to use products that offer them that. My concern is that this intervention has led to a market distortion that will continue to see a number of people move across to the cobranded products because they are attracted by the incentives they offer.

Mr Macfarlane—There were, in fact, no new entrants until we did these things. Now that we have new cards coming in, we have competition on interest rates, which never happened before in the old closed cartel arrangement.

Mr CIOBO—Are you linking it back to this reform?

Mr Macfarlane—Everyone had these really high interest rates. Now we are discovering that people like Wizard, Aussie Home Loans and Virgin are coming into the industry and offering a card with much lower interest rates for that group of people, which is actually two-thirds of the cardholders, who actually borrow on a credit card. In other words, probably lower income members of the community who actually end up using their credit card for credit, which is what it was designed for, rather than people who use the credit card for a different purpose altogether, and use it entirely as a transactions card—and the most expensive transaction medium in the country.

Mr CIOBO—But why not address the transparency issue, which to me seems to underline this? If there is greater transparency in the system, people could choose which niche they sought to operate in. I am concerned that this is going to have a distorting effect on the marketplace.

Mr Macfarlane—It is going to have the effect of reducing the average cost of the transaction in Australia. If that is a distortion, we will plead guilty to that. It is going to move people away from the highest cost transaction mechanism, which is the credit card.

Mr FITZGIBBON—Over the course of the last few months we have heard submissions from all of the players in this sector. You get different stories from each of them, of course. You will not be surprised to hear that; I am sure you have been through that process. Some of them are very passionate about their circumstances—I am sure some feigned and some more genuine. One of the more passionate submissions I heard was from the group—I forget what they call themselves now—representing merchants, including smaller merchants, who are really concerned about the growth in the market share of Amex in particular. I am pleased to hear that in the not too distant future we will have some more information about that. They are saying that more and more of these small businesses are being forced to accept Amex. They say they cannot use the surcharge because it just puts them at a further competitive disadvantage. Is this the view you are hearing from that sector and do you have any comments to make in that regard?

Mr Macfarlane—There was a survey that came out recently—

Mr FITZGIBBON—I know you were talking about big savings for merchants, of course. It just does not seem to align.

Mr Macfarlane—There was a survey that came out that said something like—I cannot remember exactly—five per cent are surcharging and 45 per cent are considering surcharging.

Mr FITZGIBBON—Do you break that down, though, in size of merchant? Even this merchants association represents everything from Coles and Woolworths down to the local corner shoe store. The aggregate could be giving you a distorted picture.

Mr Macfarlane—Once again, that market share of the ones that you are worried about is still a small market share—it is 12 per cent. When you hear them talk about it, if you did not know that, you would think it was 50 or 60 per cent. It still is a low market share. I think merchants as a whole have underestimated the power that they really have at their disposal. They are in this mindset because for 30 years they had all sorts of restrictions on them that prevented them from doing things that a normal business should be able to do; in other words, if you choose an expensive way of doing something, they should charge you more than if you choose a cheap way. For 30 years they had legal restrictions that prevented them from doing that. So some of them have actually developed a very defeatist attitude, as you just described. What we are trying to do is put the power back in their hands to actually stand up to the providers of credit cards and charge cards.

Mr FITZGIBBON—The point I am trying to make is that Amex and Diners stay outside the system and, in terms of the ability of smaller firms to compete with larger firms, the growth in market share of the Diners and the Amexes of the world—you say that is not all that large—is just another nail in the coffin of the small business, because the small business has a lesser capacity to pass the costs on to the consumer than does the larger business.

Mr Macfarlane—Most of the small businesses do not accept Amex or Diners. That is why the market share is so low. I agree that in hospitality and things like car hire, they are extremely powerful. But if you take that out, the market share is even lower.

Mr FITZGIBBON—The rewards offered by those cards cause consumers to want to use them, of course. The consumer will go around the corner to DJs to buy a similarly priced good if

they can use their Amex around the corner at DJs rather than use their MasterCard at the small store.

Mr Macfarlane—If you go down that path and say that you should let Visa and MasterCard also charge a much higher amount than they currently are—

Mr FITZGIBBON—I am not going down any path—

Mr Macfarlane—I mention that because that is what actually happens in this industry. I gave a speech called 'Gresham's law of payments' which looked at the competition between Visa and MasterCard in the US, which is deregulated. What happened as a result of that competition? MasterCard would put up its interchange fee so it therefore had more money to distribute as reward points. Visa then put its interchange fee up. A couple of years later, MasterCard put theirs up again. Visa matched it. So, over a 10-year period, competition led to an increase in prices. All the textbooks I was ever brought up on said competition is meant to lead to lower prices. Because of the peculiar structure and various agreements and things that had been entered into in this industry—

Mr TURNBULL—It is the lack of transparency that means competition does not work.

Mr Macfarlane—In this case there was transparency. Even if the merchants knew exactly what the interchange fee and the merchant service fee were, it was still going to happen. The merchants felt utterly powerless. The companies put up the fee to the merchants and could therefore offer more rewards so more people chose that card. The companies were then able to go back to the merchants and say: 'You had better make sure you accept this card because so many people have it. By the way, we are putting up your merchant service fee again.' This is a very peculiar market. All the research has demonstrated that in these markets, particularly the US market, competition leads to increasing merchant service fees. Therefore it leads to an increase year after year in the average cost of making payments. That is why this is a very unusual market. That is why this is a market that needs some form of regulation. I agree that regulation is difficult. We know—the research has been done—that the hands-off approach means year by year the cost of making payments goes up.

Mr TURNBULL—You have described what happened in America. Why would that not happen here with the charge cards? They can offer greater rewards to customers. They are attracted to Amex or Diners. They can then go to the merchant and have exactly the same dialogue as has happened in the United States.

Mr Macfarlane—Essentially, the merchants somehow or other have to get together and use some bargaining power. In a negotiation between, say, Amex and a merchant, everyone in Amex has spent every day of their lives becoming an expert and a specialist in payment systems. They negotiate with the merchant. The merchant knows how to buy and sell things and inventory control. He knows almost nothing about payments. It is an incredibly unequal bargain.

CHAIR—Would you say that applied to Coles Myer?

Mr Macfarlane—No, in Coles Myer—

CHAIR—They were at our presentation and complained about their inability to be able to exercise any market power, which is somewhat ironic because people usually complain about their excessive market power.

Mr Macfarlane—That is not what I have heard. I have heard that the big ones have actually managed to negotiate big reductions with Amex. That is the way the system is meant to work. The big ones and then the smaller ones have got these powers now to say, 'I will not take your card' or 'I will take your card and I'll surcharge if your fees are too high' or 'I will steer people towards lower cost means of payments.' By giving them that power they have been able to negotiate lower fees. That is how the system is meant to work. I suspect in the long run, when the merchants realise what power they have got, and particularly when they start talking to each other, they will start to exercise it. At the moment they are so defeatist because they have been tied down by 30 years of restricted covenants that have prevented them from using the powers that they really should have had.

Mr TURNBULL—On America, is a surcharge allowed there?

Mr Macfarlane—Surcharging was never allowed. That was the biggest single thing for 30 years that tied the merchants down.

Mr TURNBULL—So a surcharge is not allowed in America. Do their contracts have no steering provisions of the kind that have now been prohibited here?

Dr Lowe—American Express has had no steering provisions—

Mr TURNBULL—Isn't it a fact that the big difference is not so much the regulation of the interchange fee but the fact that in America—and this is the point I made about transparency; there is a lack of transparency, with respect, contrary to what you said—they cannot make the charges transparent to the customer by steering to a less expensive card or by imposing a surcharge? Do you agree with that?

Mr Macfarlane—I agree in the long run, but I do not know how long that is.

Mr TURNBULL—We are all dead in the long run, which is what Keynes said.

Mr Macfarlane—That was a crucial reform. The biggest single reform was to hand back to the merchants the power to adopt the user-pays principle which they had had denied to them for 30 years. It has been handed back to them. But the problem is that many of them have never made the adjustment, because all their working life they assumed that they were powerless when they were dealing with the banks and the charge card companies. We are trying to empower them. I am saying publicly, 'You are doing a public good if you are a merchant and you charge someone for using an expensive payment mechanism. You are helping the community. You should be congratulated.'

CHAIR—Isn't there also the possibility of the threat from the cards that they will take the card away on some other basis?

Mr Macfarlane—No, the cards do not ever want to take them away. The card companies only want you to have cards. I have never heard of them threatening to take them away. They would be at the end of their business if they took them away.

Mr FITZGIBBON—Another lobby group that I have spoken to—which carries a look of desperation and frustration in their collective eyes—is CUSCAL, representing the issuers of Visa Debit Card. They claim that the regulation of the interchange fee and the driving down of that price is going to have all sorts of consequences, most of them adverse not only to them but to the rest of the regulatory payment system. Could you comment on or respond to their views?

Mr Macfarlane—I hope that they also pointed out to you that the Visa Debit Card is a debit card. There was no line of credit attached to it at all and yet it charges an interchange fee as though it were a credit card. So the Visa Debit Card is in fact a debit card masquerading as a credit card. When you go in and you use it you are using your own money—it simply debits money from your own account. But the merchant has to pay a merchant service fee as though it were the much more expensive product called the credit card. There is a basic case of misrepresentation there. As Malcolm was saying, it is really all about transparency. That is the ultimate example of non transparency: a debit card being charged for as though it were a credit card, because it is designed to fool the merchant into thinking it is a credit card. We cannot continue with that sort of misrepresentation. Even though the credit unions are doing nicely out of it, because they issue them and therefore they receive the interchange fee as though they were issuing a credit card, they are not credit cards. They are only issuing a debit card.

There is a more fundamental thing there. The more fundamental issue is the whole future of the debit card industry or the EFTPOS industry. In Australia at the moment we have this peculiar situation—we are the only country in the world that has it—whereby, if I am a bank and I issue you with an EFTPOS card, every time you use it I have actually got to pay money out. But if I issued you with a credit card, every time you use it I receive money in. In the long run what do think the banks are going to do? In the long run it is in their interest whilst this continues to allow the whole EFTPOS system to dwindle and move everyone onto credit cards. Our starting point to this deregulation was very difficult. That is an absurdity which we have in Australia for historical reasons that no-one fully understands and no-one else in the world has. We have a starting point that it is very difficult to deregulate from.

Ms GRIERSON—I must say that we have had submissions from all stakeholders except consumers. If the resistance is any measure of the need for these reforms, then I think we should bring them on, on behalf of consumers. That there are new players in the market suggests that they have been very effective, in that the reforms are already bringing about competition. Have you any evidence about merchants taking up these new cards and therefore passing on savings to consumers?

Mr Macfarlane—The interesting thing is that the new cards have tended to focus on those two-thirds of credit card holders who actually borrow. In other words, they use the credit card for what the credit card was originally designed for, which is credit. These people have realised that, if you issue cards to this particular group of people, you can actually lower the interest rate from 16, 17 or 18 per cent, which it traditionally was, to 10 per cent—10 still sounds quite high; one of them has a rate of 9. 99 per cent. You can lower it to that level and still make a very nice business out of providing credit cards for people who are going to be paying this 10 per cent

every month. So this whole new class of credit card has arisen, specifically designed for people who actually know that they are going to borrow against their credit card. In fact, two of the banks have retaliated and have also now introduced low interest rate credit cards aimed at this particular part of the market.

Ms GRIERSON—The resistance to EFTPOS changes is phenomenal, yet there is such a heavy demand and usage at such a high cost. What do you think perhaps will be the projected savings from the fee changes to the use of EFTPOS?

Mr Macfarlane—There are two things. While we have put out a document for discussion, we have not exactly announced where we are going to go on that path. But the biggest single reason for the reform of EFTPOS is the one that I alluded to before: it costs the issuer money to issue an EFTPOS card whereas they receive a lot of money when they issue a credit card. If we do not do something about that, in the long run we will not have an EFTPOS system.

Ms GRIERSON—It is definitely a risk.

CHAIR—Mr Somlyay?

Mr SOMLYAY—I have some questions about the final tranche of the payment system—the ATM reforms. Is it right that the ATM interchange may have stalled because the industry was unable to agree to a model of self-regulation that is competitively neutral and good for consumers? What does the RBA intend to do about that? Do you intend to intervene?

Mr Macfarlane—This is a very interesting one, because I think what you are saying is correct: the attempt by the industry to move to a better system has stalled. The industry is saying to us, ‘Please come in, regulate it and sort it out for us.’ It is not as though we are the big bad regulator that everyone is trying to keep out; here the industry wants us to come in. At the moment we are a little hesitant about coming in, although we may ultimately have to do so. Dr Lowe might like to add to that.

Dr Lowe—A year ago we asked for public comment on whether we should designate the ATM system. Almost to an institution everyone said, ‘Please give us time; we want to try and work something out voluntarily.’ We have given them a year and, as you say, it looks like the reforms have stalled. The reason they have stalled is that various parties—various banks and ATM deployers—have different visions about what the future looks like and they cannot agree on a model. At the moment, we are having discussions with all those parties to see where there is room for a consensus model to emerge and, if there is not, what the Reserve Bank should do about that. But we are still in the process of having those meetings.

Mr SOMLYAY—Do you have a time line as to when you run out of patience?

Dr Lowe—I think the voluntary process, without some further direction by the bank, has pretty much run its course. In the next month we will have finished meetings and then the Payment System Board will have to take some view about what the next step will be.

CHAIR—I refer to the advice to users of ATMs to view on the electronic screen the charge that is being allocated if they are not a cardholder at that particular bank. Has that been agreed to as part of the proposal?

Dr Lowe—There are two issues about transparency. The first issue is the transparency of the price that the ATM owner charges you and the second is the transparency of the price that your own bank charges you. In Australia, ATM owners do not charge you directly for using an ATM. Under the direct charging models that the industry is looking at—if they go down that route—the ATM owner would certainly advise you of the charge before the transaction was completed.

The second issue is the transparency of the charge that your bank charges you if you use another bank's ATM. In a perfect world, that might come up before you have actually completed the transaction. The difficulty, though, is that the ATM does not know what your bank is going to charge you when you use that machine. So technologically it is quite difficult for the ATM to display to you what your bank is going to charge you if you make a transaction. It is not impossible for that to be done, but it would be quite costly to do. My understanding is that at the moment there is not a proposal to tell cardholders what their own bank will charge them if they use another bank's ATM.

CHAIR—There are no further questions from the panel on the payments system. I now invite Matt Pareira Smith from St Kevin's College to read out his question.

Matt Pareira Smith—Good afternoon, Mr Macfarlane and board members. Figures released recently show that the usage of credit and debt cards has been increasing. In fact, that usage is approaching all-time highs. Do you believe that reliance on credit for consumption is reaching dangerous levels and, if not, is it getting close to those levels? Also, what can the Reserve Bank do to counter such a situation?

Mr Macfarlane—Even though this is a very important question, it is unfortunately a question which we, the Reserve Bank, have no responsibility for. It is really a question of consumer protection. We are not the consumer protection authority. What we are responsible for is the efficiency of the payments system. We want Australia to have a payments system which is low-cost, very innovative—so all the good products are available here—and safe. That is what we are responsible for. I know that a lot of the state credit agencies and others are concerned about the excessive use of credit cards and people who get multiple credit cards and then find themselves in serious debt. I have no doubt that that is a social problem, but unfortunately I have to say it is not a problem that we have any ability to change; nor do we have any responsibility—we are not given the powers in our act—to do anything about it.

CHAIR—We have had agreement with the deputy chair that we will probably, rather than going back to general economic questions, wind it up after a further question from Nicholas Kefalianos.

Nicholas Kefalianos—Good morning, Governor. Recently, through fiscal consolidation, we have noted a dramatic decrease in the level of public debt, yet it appears that private debt is soaring. Does anything have to be done to address this problem of private debt?

Mr Macfarlane—It is interesting how people are concerned about this. Most people instinctively, and probably quite rightly, worry about debt when it is rising. The problem is that none of us actually knows what the optimal level is or what the dangerous level is. We know that it was potentially very dangerous when household debt was rising at over 20 per cent per annum, as it was for a couple of years. The worst thing it was doing, in my view, was driving up a very important asset price—the housing price—out of many people's reach. We do not know whether it was actually causing households to put themselves in a vulnerable position. We do not know at what level that occurs.

I do not think it is quite as bad as it sounds, because, as I have pointed out on previous occasions, most household debt is housing debt—mortgage debt. Only 30 per cent of households have a mortgage; it is a surprisingly low number. Of that 30 per cent of households, a lot have had the mortgage for a reasonable period and, during that period, their incomes have gone up or they have paid off part of their mortgage. The vulnerable group is the people who have just taken out a mortgage, and it was ever thus. The one time in your life when you are vulnerable, when you have a high amount of debt relative to your income, is when you first take out a mortgage. We do not know just how many people are in a very vulnerable position. I am very sorry that I cannot give an answer. I would like to be able to give an answer and say that, when household debt to household income reaches 170 per cent, that is the critical level, but we do not know what the critical level is.

CHAIR—Having said, Governor, that we had no further questions, Sharon Grierson proposed a couple to me which I think are probably appropriate to the nature of this inquiry. Would you mind answering them?

Ms GRIERSON—They are only quick ones. It has been raised that there were some concerns held by the Reserve Bank regarding the accuracy of GDP measures. Have you made any progress or have you looked at different measures?

Mr Macfarlane—No, it is not our job to do that; it is the job of the Bureau of Statistics to do that. I would like to say a couple of things, though. People wrote up our last hearing as though I was attacking the Australian Bureau of Statistics; that was not the case at all. I think we have a very good statistical bureau, but statistics is a very approximate science and there are always going to be difficulties, no matter how good you are, in getting to a very precise figure.

The second thing I ought to mention is that, even though most people think about GDP as being the principal economic statistic, it is not actually a crucial statistic for current policy making. The reason for that is: here we are in August, and the most recent GDP figure we have is for the March quarter. That is the average of the three months in the March quarter over the three months in the December quarter last year, so that is a growth rate centred on the month of January. The fact that there may be problems in interpreting GDP is actually not very important for our decision making, although people will come along after the event and, when the figure finally arrives, try and score a point or two. But, in terms of our decision making, we are not making it on the basis of GDP figures.

Ms GRIERSON—It has been suggested that commodity prices may have peaked, or have peaked. In your statement today you said that you think that is offset by the increased export

volumes. How long do you think that can continue? What are your projections in terms of commodity prices?

Mr Macfarlane—None of us is confident about forecasting commodity prices. The body whose job it is to do that in Australia is ABARE, the Australian Bureau of Agricultural and Resource Economics, and they find it very difficult. People who have been in the industry all their lives find it very difficult. People in the coal industry all their lives were astonished by what happened to coal prices, as were people in the iron ore and oil industries—it is very difficult to predict these things. What you tend to do when you are making a forecast is either you put in 'no change' or, if the recent movement has moved you to an extreme position, you put in an assumption that you will go back to a more normal position, because you do not actually profess to have any inside knowledge.

Mr TURNBULL—Isn't part of the problem, Governor, that the demand for coal—so, the demand for energy—is much more dynamic? That is to say it can increase much more quickly than you can increase supply—that is, open new mines.

Mr Macfarlane—Yes, indeed, and that is what gives rise to the extreme fluctuations, called a 'hog cycle' by some and a 'cobweb theory' by others.

Mr TURNBULL—Thank you.

CHAIR—Thanks very much, Governor. It was a very useful discussion. Obviously, there have been other periods where probably the questioning was much more robust. Considering where we sit and the strength of the economy, I think your co-workers could well take some long service leave! But that is another question. I would like to thank all participants. The hearing is adjourned.

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

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

Committee adjourned at 12.46 pm