COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Reserve Bank of Australia annual report 2005

FRIDAY, 17 FEBRUARY 2006

CANBERRA

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Friday, 17 February 2006

Members: Mr Baird *(Chair)*, Dr Emerson *(Deputy Chair)*, Mr Ciobo, Mr Fitzgibbon, Ms Grierson, Mr Keenan, Mr McArthur, Mr Secker, Mr Somlyay and Mr Tanner

Members in attendance: Mr Baird, Mr Ciobo, Dr Emerson, Mr Fitzgibbon, Ms Grierson, Mr Keenan, Mr Somlyay and Mr Tanner

Terms of reference for the inquiry:

Review of the Reserve Bank of Australia annual report 2005

WITNESSES

Committee met at 10.03 am

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

EDEY, Dr Malcolm Lawrence, Assistant Governor, Economic, 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 Standing Committee on Economics, Finance and Public Administration. I welcome representatives of the Reserve Bank of Australia, students and staff from secondary schools in the Canberra area, members of the public and the media. I understand the secondary schools group is leaving at 11.30 am. At 11.25 two students will be given the opportunity to come down here for the great privilege of asking a question of the Governor, so choose your best question!

The hearing today provides an opportunity to examine the state of the economy, focusing on inflationary forecasts and the implications these have for monetary policy. In addition, the committee is keen to discuss Australia's economic growth, the current account deficit, variations in employment by state, and potential wage pressures. The committee will also examine the RBA's objective of keeping consumer price inflation between two and three per cent. The possible advantages of lowering the inflation target to between one and three per cent, for example, should be explored.

A further issue that the committee wishes to explore is the transparency of the RBA's decision compared to approaches used internationally. The US Federal Reserve, for example, releases minutes of its meetings three weeks after the date of a decision. The Bank of England's Monetary Policy Committee meets every month and its minutes are released two weeks after the announcement of its decision. In contrast, the RBA meets monthly but does not publish its minutes and does not publish an explanation for its decision if it is not changing the setting of interest rates. The RBA's approach to disclosure and transparency will be examined.

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, these hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. Mr Macfarlane, would you now like to make your opening statement before we proceed to questions.

Mr Macfarlane—Thank you, Chair. It is a pleasure to be back in front of the committee and to be having this hearing in Canberra for the first time in a number of years. When I look at the committee in front me I note that the membership has changed quite a bit, particularly on the government side. Of course that is something that has happened pretty continuously during the ten years that I have been reporting under the current arrangements and it has not interfered with the committee's effectiveness.

As you know, we had our February board meeting last week and we issued our quarterly statement on monetary policy, which is this document, earlier this week. This document spelt out in detail how we see the current situation in the economy and why the stance on monetary policy is where it is. This morning I would like to take the opportunity of not just going over what is in that document but looking at the situation from a broader perspective.

I will take as my starting point Australia's current economic expansion. For years I have made the point that winding back economic slack is not made by high growth in any individual year but by maintaining an expansion over a sustained period. Australia's current expansion began in late 1991 and is now in its 15th year. This means that it is already significantly longer than its predecessors in the sixties, seventies and eighties. The expansion has been marked by good growth of GDP, which has averaged 3¾ per cent per annum over this period, which is one of the best if not the best in the developed world. You can find small countries like Ireland and Luxembourg that have done better, but you do not find too many big ones. I do not think you find any other big ones.

A consequence of the sustained expansion is that the economic slack generated in the last recession has been gradually used up. One indicator of this obviously is the unemployment rate, which has trended down from a peak of about 11 per cent to be currently just over five per cent. Other indicators of the economy's capacity utilisation are also at cyclically high levels. Business surveys report that businesses are operating at close to their highest levels of capacity utilisation since the late eighties. Their surveys have also been reporting high levels of labour scarcity. For the past year or so many businesses have been in the unusual position of reporting that scarcity of labour was a bigger constraint on their activities than their traditional concerns about the adequacy of sales or demand. This applies to both large and small businesses.

Given the maturity of the expansion, it is not surprising that the average growth of the economy is now less than it was in earlier stages. As a general principle, it is easier for an economy to grow quickly when there is a large pool of unused resources to be re-employed. In Australia's current position in the cycle, that source of growth is now much more limited. So, in the absence of a significant lift in trend productivity, we should expect to see GDP growth rates mainly in the twos and threes rather than the threes and fours, as was typical for most of the expansion. I think I made that point using almost those words at our last meeting six months ago. It is not surprising, therefore, that the growth of the economy over the latest year for which data are available was 2.6 per cent. If we annualise the most recent two quarters, it is three per cent.

Business investment has been a major driver of growth in recent years, expanding by 18 per cent over the past year and by an average of 14 per cent per annum over the past three years. The upswing in business investment is being stimulated by high commodity prices and favourable financial conditions. With strong investment growth and an expected improvement in exports, our forecast for the economy overall is that annual growth in GDP will pick up modestly during 2006 to about 3¼ per cent. While strong business investment obviously contributes to capacity expansion, the sorts of outcomes envisaged for GDP growth would imply the economy will continue to operate at close to full capacity.

While the overall growth of the economy during the current expansion has been good, there has been concern expressed about its composition. Some aspects of the composition are excellent—the fact that investment has picked up and is now much stronger and that consumption has slowed. But other aspects of composition have caused concern—in particular, the fact that the growth of the economy over the past few years has been more than fully accounted for by growth in domestic spending, while Australia's export performance has been disappointing. In consequence, the current account deficit has remained high, at about six per cent of GDP, despite a strong international environment and rising commodity prices. Notwithstanding these concerns, it needs to be emphasised that monetary policy cannot be expected to target a particular composition of growth or current account deficit. Any attempt to do so—for example, by running a much tighter monetary policy in order to constrain domestic demand—would be counterproductive and would detract from the bank's broader macroeconomic objectives.

Now I would like to talk about the global business cycle. Australia's economic situation should also be viewed against the backdrop of the global business cycle. In broad terms, business cycles across various countries have tended to move together, at least among countries in the developed world—that is, there has been a reasonably high correlation in the timing of recessions and expansions among developed countries over the past few decades. Nearly all of the advanced countries experienced recessions in the mid-1970s, the early 1980s and the early 1990s and many did so again in 2001. It is relatively unusual for countries in this group to experience what might be called a home-grown recession—that is, a recession not shared by the other major industrial countries. Similarly, it has until fairly recently been unusual for countries to skip an international recession, although Australia and a couple of others have recently done so, as did Japan in the early 1980s. This is not to say that domestic conditions and policies are unimportant. Nevertheless, as a general rule, when the world economy as a whole is in a sustained expansion, there is a very good chance that an expansion will also be continuing in an economy like Australia's.

Currently, the world economy is expanding strongly. The recovery from the global downturn in 2001 is now well established and, on past experience, the expansion will still have a good few years to run. While growth to date has been mainly led by the United States and China, there have been encouraging signs over the past year that growth is becoming more broad based, particularly with a couple of the laggards starting to improve—and here I refer in particular to Japan but also, to a lesser extent, the Euro area. Assessments of the risk to global growth have focused mainly on the effects of higher oil prices and on the possibility that the US current account imbalance will have a disruptive effect on the world economy. However, there is little sign that these forces are restricting growth at present. World GDP growth in 2005 is estimated to have been above average and most observers expect this to continue in 2006.

The growth performance has been accompanied by generally subdued inflation outcomes. One factor behind this was the increased focus on inflation control by central banks around the world after the high inflation of the seventies and eighties. Many central banks have now adopted numerical inflation targets, and others have clearly become more focused on inflation control even without adopting explicit targets. At the same time, the importance of structural factors and, in particular, the industrialisation of China, should be recognised. The huge pool of low-cost labour that this has brought into play has put sustained downward pressure on a wide range of prices of internationally traded goods.

One consequence of this strong world recovery has been a marked upswing in Australia's terms of trade, defined as the ratio of our export to import prices. Currently, Australia is benefiting from the largest cumulative increase in our terms of trade since the early 1970s. The main factor driving this has been the rapid growth in global demand for resources, with China in particular playing an important role. As a result, world prices for a wide range of resource commodities have been increasing sharply.

Over the past three years, Australia's terms of trade have increased by 30 per cent. This is estimated to have added 1½ to two percentage points per annum to the growth in national income, or our real income and capacity to spend over this period, which has been a significant expansionary force on the economy. The effect of this can be seen in a number of areas, including strong growth in business investment, company profits, share prices and imports. Increased export prices also tend to boost government revenues through company taxes and a range of federal and state royalties.

I will now turn to interest rates and financial markets. Although Australia avoided the recession that engulfed many developed countries at the start of this decade, it was not totally unaffected by world events. The bank found it necessary in 2001 to cut the cash rate to 4.25 per cent in a series of steps. While this was a new low for Australian official interest rates—the previous low had been 4.75 per cent on a couple of occasions in the 1990s—it was a relatively muted response compared with the very large cuts in interest rates that occurred elsewhere in the world. Winding the clock forward, in mid-2002, with both domestic and global economic conditions improving, the bank began the process of restoring official interest rates to more normal levels. It did this in five steps over three years: two in mid-2002, two in late 2003 and one in early 2005. This was a more gradual tightening cycle than normal.

At the current level of 5.5 per cent, the cash rate is in line with its average over the low-inflation period since 1993. There is therefore a sense that the current level is relatively neutral in terms of its impact on economic activity and inflation. One complication in assessing the level of interest rates, however, is that competition in the financial sector has seen margins between the cash rate and the lending rates of institutions narrow over recent years. The interest rates faced by borrowers are still a little below average.

Australia moved to restore normal interest rates well ahead of other developed countries. All the major countries had reduced interest rates to unprecedented levels in the early part of this decade—nought per cent in Japan, one per cent in the United States, and two per cent in the Euro area. They maintained this position for a prolonged period. Of the major countries, the United States was the first to raise rates, with the Fed beginning to tighten in mid-2004. The European Central Bank has only just started the process in recent months, and the Bank of Japan is not expected to start lifting rates for some time yet. Even though the Fed has now restored the funds rate to a relatively normal level of 4.5 per cent, world policy interest rates on average remain well below normal.

Another unusual aspect of current global interest rates is that long-term rates, which are set by demand and supply for funds in capital markets, not by central banks, have remained quite low in the face of rising official interest rates. Although various explanations have been put forward for this unusual behaviour, the most likely cause is the ex-ante excess supply of savings relative to investment in large parts of the world, with Asia accounting for most of this excess in global savings.

For equity markets, the combination of low interest rates, strong economic growth and low inflation has proved very beneficial, with global share markets rising solidly in each of the past three years. This has been underpinned by strong growth in profits so that, notwithstanding the rise in share prices, price earnings ratios have been declining on average.

It is worth noting that the Australian share market has behaved quite differently from the global market over the past decade. It was affected much less than most markets by the tech bubble and its subsequent collapse and in recent years has been rising a good deal faster than average. Along with the Canadian share market, it is the only market that is currently above earlier peaks—well above, in fact—whereas in Europe and the United States share markets are still about 20 per cent below their early 2000 peaks.

The Australian dollar has remained in a relatively steady range over the past couple of years, at levels that are a little bit above average against the US dollar and about 10 per cent above average in trade weighted terms. The currency has been remarkably stable over the last two years. Some people have found this steadiness puzzling against a background of continuing very strong rises in commodity prices and our terms of trade, as such episodes in the past have been associated with strong rises in the currency. I think a key to understanding the different behaviour on this occasion is the change in the interest rate differential with the United States. This has narrowed appreciably over the past 18 months because the Fed has tightened much more than we have.

Domestic credit and debt is a subject which we have talked about frequently in front of this committee and elsewhere. I would like to say a little more about it today. I will divide the subject into two aspects. The first is the shorter term cyclical fluctuations in household credit growth and the second is the fact that various debt ratios have trended upwards over time. Regarding the first of these issues, the most recent cyclical peak in household credit occurred around the end of 2003, when it reached an annual rate of over 20 per cent. Since the bulk of household borrowing is housing related, it is not surprising that this phenomenon was closely associated with a sharp run-up in house prices. Nationwide house prices increased strongly for several years up to late 2003, reaching a peak growth rate of around 20 per cent in that year. The increases in credit and house prices were interrelated, with credit availability fuelling price rises, while rising house prices meant people had to borrow larger amounts to achieve home ownership. Much of this behaviour was driven by expectations, particularly in the investor market, of future price gains—the classic definition of bubble-like behaviour.

In the period since late 2003 both the housing market and the demand for credit have cooled. Nationwide house prices have been broadly flat over the past two years and prices have fallen in Sydney. Household credit growth has eased back to an annual rate of about 12 per cent. Although this might still be regarded as quite high in absolute terms, it is towards the lower end of the range in which it has fluctuated in the past two decades. While there are some tentative signs that credit and housing market conditions have firmed a little in recent months, the risk to the economy posed by the overheating in housing and credit markets in the period up to late 2003 has eased. Households now seem to have entered a period of greater financial caution and this may act as a restraining influence on the growth of household spending for a while to come, as it has to date and as is shown by the modest growth of household consumption.

The second issue is the high average growth rate of household credit over an extended period—a couple of decades. This is a longer run issue and one on which it is more difficult to make firms judgments. For more than a decade, household indebtedness has grown at a rate well in excess of the growth in household income. This has meant that the aggregate ratio of household debt to household income has trended upwards, as has the proportion of household income required to service debt and the gearing ratio, which is the value of debt to the value of household assets. All those three ratios have trended upwards over a long period of time.

Simple rules of thumb would suggest that this cannot be sustained indefinitely, yet there are a number of reasons why these ratios may rise further. In a low-inflation environment, nominal interest rates are also low and households are able to service much higher levels of debt than they could in the past. A significant proportion of households still carry little or no debt and in the years ahead might choose to borrow more. Attitudes towards borrowing appear to be changing, with people becoming more willing to borrow against assets later in life.

For these and other reasons, it is quite possible that the rise in household debt ratios could go a good distance further. The risk, of course, is that the process goes too far and that a painful correction ensues. There has been much debate around the world about the role of monetary policy in these circumstances, with the consensus being that the best it can do is to continue to pursue the general objectives of macroeconomic stability and low inflation.

We should also not forget the influences on the supply side when thinking of household credit and debt. Banks and other providers of credit to households have been competing vigorously to expand or to protect their market share. In the process, lending standards have been progressively eroded so that lenders are now engaging in practices that would have been regarded as out of the question five or 10 years ago. These are matters in which prudential regulators are taking a strong interest.

While the growth of household borrowing has been relatively high throughout the current expansion, business borrowing on average has been more restrained. This is the reverse of the pattern that was observed in the 1980s and, as a result, the business sector generally is in good financial shape, with low levels of debt. In the past two or three years, businesses have begun to take advantage of that position by again expanding their borrowing and lifting the rate of growth of their investment spending. Business credit has thus strengthened quite markedly, so that it is now growing at a rate of 16 per cent—well above that for the household sector.

I will conclude by saying a few words about inflation. Australia’s inflation performance over the past decade or so has been consistent with the bank’s medium-term target. Since 1993, when the two to three per cent objective was first articulated, average CPI inflation—excluding the one-off GST effect—has been 2.5 per cent per annum. Of course, the inflation rate has inevitably fluctuated quite a bit from year to year, including periods where it has been above three per cent and below two per cent. But it should be remembered that the bank’s objective is expressed in terms of average outcomes and should not be thought of as a rigid commitment to eliminate short-term fluctuations in inflation. In the latest year, inflation in underlying terms has been close to 2½ per cent, though the headline CPI figure is higher, principally reflecting the effect of the rise in fuel prices.

While inflation has remained contained over the past decade, it is important, as always, to consider how inflationary pressures might evolve from here. At the current stage of the expansion, there are a number of factors that might be expected to put upward pressure on inflation. The economy is operating at a high level of capacity utilisation, the labour market is relatively tight, and there have been some large increases in raw material costs. Aggregate wages growth has picked up over the past year, and businesses generally are reporting difficulty in attracting labour. These conditions underpin the current forecast of a modest rise in underlying inflation over the year ahead. Based on the current level of oil prices, this forecast implies that headline CPI would remain close to three per cent over the forecast period.

This outlook is, as usual, subject to significant uncertainty. One area of uncertainty relates to wages growth, where there is a risk that current labour market tightness will result in higher than expected wage increases. This will be an important area to watch in the months ahead. On the other hand, the latest CPI figure was a little below expectations and may indicate that global disinflationary forces are stronger than had been expected. There are also some tentative signs that conditions in the labour market may be easing slightly. The issue, over the period ahead, will be whether these latter forces prove sufficient to contain inflation in an economy operating with little spare capacity.

In these circumstances, the board, at its recent meeting, judged the current policy setting to be broadly consistent with the economy’s requirements for the time being. Looking ahead, however, it felt that, on balance, based on the considerations I have outlined here today, it is more likely that the next move in interest rates will be up, rather than down.

CHAIR—Thank you very much, Governor. We appreciate your comments and your coming here today. You say that it is more likely that the next move in interest rates would be up rather than down, which follows the general tone of the statements put out by the Reserve Bank in the last few weeks. Yet we note that pricing in the financial markets indicates that the market believes official interest rates are more likely to be lowered than raised. For example, the futures market pricing of bank bills shows a 40 per cent chance of a rate cut by September. Is this something that the RBA is comfortable with, given that expectation of a rate cut might encourage borrowers to take out more debt?

Mr Macfarlane—That is an interesting issue that you raise, because it is not confined to Australia. It is part of the general issue of why long-term interest rates and even medium-term interest rates are so low. The US faces the same situation. Everyone expects interest rates to go up twice in the US—that is looking at six months—and then their yield curve says that they go down again. I know that the Fed cannot understand that, and they think there is something funny going on in the yield curve. We have not got anything quite as anomalous as that, but you are right that our yield curve has a slight downward slope.

Interestingly, another source of information about the likely future movement in interest rates is the surveys of business economists. They do not agree with the yield curve, because more expect interest rates to go up than to go down, so they have the same sort of assessment that we have. This conflict between what the yield curve or what the traders, the market, are saying about the future and what the economists—either those in the private sector or economists in central banks—are saying and thinking—this contrast—has been going on for a couple of years. Some people even take it further. They say, 'If you've got a downward sloping yield curve, that means the economy's going to contract sharply' or something. They have been saying that some time too, and of course it has not been happening. Around the world economies have been growing very strongly and some of the weaker economies have actually been picking up. So I think we have to treat the evidence from the yield curve with some degree of scepticism and bear in mind that it is affected by this phenomenon of downward pressure on medium- and long-term interest rates that has been occurring in every country and taking everyone by surprise for a very long time.

CHAIR—Is it the wish of the committee to authorise the publication of the statement by the Governor of the Reserve Bank? There being no objection, it is so ordered. I would now like to move to the question of what appears to be duality in terms of the development of the Australian economy. On one side of the nation we have a strong growth rate in Western Australia, an unemployment rate of about four per cent and a rise in house prices and demand. On the other side of the continent, in Victoria and New South Wales in particular, we have greater sluggishness and growth in the unemployment level—5½ per cent in New South Wales. It would appear that we have a greater divergence of the economies within the country than we have had for the last 20 years. So the question is: do you see this as a challenge in managing the diversity that we have in the country in terms of such differences? As part of that, do you see that some economists would suggest that New South Wales is being punished because that is where housing prices went up the fastest so that when they drop the propensity to spend is reduced? Is it a result of monetary policy or is it a result of government inaction in New South Wales as well? I raise that question because obviously people are interested in the development of what we have in two areas of the country—such diversity.

Mr FITZGIBBON—Or the different mix of fiscal and monetary policy at the federal level?

Mr Macfarlane—I have too many questions here. Bruce proposed about three. I want to start by saying that, for most of the 10 years that I have been coming before this committee, someone on the committee would say: 'You've got two different parts of the country. Sydney is overheated and the rest of the country is not. And aren't you overly influenced by Sydney when you make your interest rate decisions and when you put up interest rates?' For most of this period that has been the theme of the questioning.

CHAIR—It is still part of it today.

Mr Macfarlane—Now it is almost the reverse. The New South Wales economy, in particular, is lagging and so is Victoria to some extent. A lot of people are saying, 'What's gone wrong in New South Wales?' There will always be some states that grow above average and some that grow below average. We hope that it switches around from time to time. So if you have a period where you are growing above average, or particularly if you have had a period where you have grown below average, you get an opportunity to catch up. I do not see any evidence that the dispersion of growth rates, employment or unemployment rates is any greater than it has ever been. Even though, as you said, Western Australia has zoomed ahead and Queensland has a little too, New South Wales fell back to the pack and now it has fallen a bit behind the pack. South

Australia and Tasmania have done much better than anyone thought they would and they have come closer to the average.

Looking at Australia as a whole, the economic performance is not becoming more diverse. Australia is noted for having relatively small differences between states compared, say, to Canada, where the Maritimes have unemployment rates twice as high as those of the prairie states, or the United States, where again there are huge divergences between states. Australia is noted for having relatively small divergences. I do not think that the divergences have got any bigger. There has just been a shuffling of the order. That is the first answer.

The second answer, which is the important reason behind the shuffling of the order, has been the big lift in the terms of trade and the enormous boost this has given to the resource rich states, particularly Western Australia and to a lesser extent Queensland. That has given their economies a much bigger spurt than it has to the economies in the south-eastern corner of the country. Thirdly, when we look at New South Wales—as I said last time we met—I do think it had an earlier and bigger boom and bust in house prices than the other states.

CHAIR—Do you think that was connected with their coming off the Olympic boom?

Mr Macfarlane—I think that had something to did with it. If you go back to that period around the turn of the century, you discover that New South Wales stopped overperforming and started to underperform a bit. The housing market continued to grow for two or three years after that. But I think a combination of those two things—the housing and the Olympics—led to more overheating in New South Wales, particularly in house prices, and, as a reaction to that, we have seen significant net emigration from New South Wales. It is a subject we discussed last time we were here. I think a combination of those factors explains to me why there has been a shuffling in the hierarchy amongst states, where some of the laggards are now leading and some of the ones that were leading are now lagging.

CHAIR—My final question, before I pass over to Dr Emerson, is that some economists have been suggesting to us that perhaps it is time to explore changing the targeting of our inflation rates. We have traditionally set our target rate between two and three per cent and that, with the target rate, inflation will move 2½ per cent and our interest rates seem to follow automatically. If we targeted an inflation rate of two per cent then after some period of adjustment we would find nominal interest rates would then move to two per cent. Switzerland has a target inflation rate of one per cent and the euro area of 1.9 per cent. The UK, Canada, Sweden and New Zealand have chosen two per cent. Do you feel that it is time to re-examine whether our target rate is a little high and that we should reduce it with a net benefit of a lowering of interest rates?

Mr Macfarlane—There are a number of dimensions to the question. I will start with the first one. Under the orthodox operation of an inflation-targeting framework the government sets the inflation target, and it says to the central bank, ‘This is your remit; you have to achieve that.’ We are a little bit unusual in this country in that, in the first half of the nineties—we are the only country I can think of where this happened—the central bank quietly introduced the concept of an inflation target and started talking about it. It was not actually introduced by the government. Although the Treasurer of the previous government was himself prepared to quote it from time to time, it never really got the full endorsement.

With a change of government, we have now switched to the orthodox situation where the government lay down the inflation target. We were very pleased that they laid down the one that we had already suggested. But in the statement on the conduct of monetary policy, which I signed with the Treasurer, it says, ‘The government respects the independence of the Reserve Bank, as contained in the act, and gives the Reserve Bank the task of achieving this particular inflation target,’ which is an average rate of inflation of two to three per cent. If there was a big discussion of the subject in Australia—and there was some consensus that a different or lower target would be better—then it would be up to the government to take the next opportunity to revise their statement on the conduct of monetary policy and put in a different target. In this case the suggestion is a lower one—a one to three rather than a two to three.

I do not want to prejudge the position. As I say, it will be up to the government to decide that. My inclination would be that they probably would not be interested in it, because it seems like very finetuning—half a per cent is a very small change. Even with those slightly different targets that countries have, if you look at the last 10 years, you will see the variation in inflation has been very small. Over the last 10 years the highest inflation rate was that of the UK at 2.6 per cent; the US, 2.5 per cent; Australia, 2.3 per cent; Norway and Canada—and other inflation-targeting countries—2.1 per cent; New Zealand, two per cent; and, the euro area, 1.9 per cent. Over a decade, the variation between this vast array of countries was between 1.9 per cent and 2.5 per cent. Because the inflation targets and inflationary outcomes amongst countries are so similar, I think it would be difficult to make a very persuasive case to go through the effort, particularly at a time when inflation is under upward pressure of unilaterally declaring you want to lower the inflation target. But it would be up to the government, if they saw a sufficiently persuasive case to do that, to do it.

Dr EMERSON—I have three questions. The first one relates to your statement today. On page 8 you identify three forces that are exerting upward pressure on inflation: high level of capacity utilisation, a tight labour market and an increase in raw material costs. You similarly identified those influences in the statement of monetary policy issued on 13 February. In the conclusion of your statement today, it says:

Looking ahead, however, it felt that on balance, based on the considerations I have outlined here today, it is more likely that the next move in interest rates would be up rather than down.

Whereas the end of the statement on monetary policy issued on the 13th says:

However the Board recognises that policy would need to respond in the event that demand or inflation pressures prove stronger than currently expected.

I sense a bit of a firming of intention or a tightening of the rhetoric there in today’s statement where you are explicitly saying it is more likely that the next move in interest rates would be up rather than down. I think the reporting out of the statement of the other day shows that, while there is a tightening bias, you are moving to a slightly more neutral position. It would seem to me that you could not conclude that out of today’s statement, that the tightening bias is well and truly there.

Mr Macfarlane—I am sorry if I give that impression because the two statements were meant to be essentially the same. It shows you how careful you have to be with words. I think the difference is that I wrote the words to this one and Malcolm wrote the words to the previous one.

Dr EMERSON—You and Malcolm have a different view?

Mr Macfarlane—No, he does not.

CHAIR—You are one.

Dr EMERSON—A split in the Reserve Bank.

Mr Macfarlane—They are meant to say essentially the same thing. It is not meant to say, ‘We have a plan.’ Some people use the word ‘bias’. I think the bias means, ‘We’ve all sat down and we’ve this plan, but we’re not going to tell you about it.’ In fact, what we are saying here is not that at all. We have no present intention. We are saying that history tells us that normally at this stage of an expansion it is far more likely that upward pressure on inflation will prevail and you will need to react to it. That is all we are saying.

CHAIR—Given the discrepancy that we can see today, is there a need when you put out your quarterly statements to provide some explanation as to how you reach that conclusion? I hear from the financial markets that in doing their projections it is often difficult if there are no reasons given—it is just a bland statement—which contrasts with what we see in a number of countries overseas.

Mr Macfarlane—I think you are saying we should have had another go at the end of the board meeting and put out a statement. In that case you would have three different sets of phrasing and it would probably confuse people even more—or we would then become like a machine with some prearranged form of words which we would never be able to deviate from; we would make sure that everything sounded exactly the same. And I think that is what tends to happen. If you communicate frequently—every month—you run the risk of using a slightly different form of words, as I just did. So, to avoid that risk, you end up with statements which are almost pro formas—they are almost exactly word for word from month to month and maybe one word will change. In the US over the last three or four months, everyone has been able to predict correctly what is going to happen to interest rates. So there is no excitement about predicting what is going to happen to interest rates. All the excitement is now directed to what the words will be in the statement that accompanies the movement in interest rates. There the attention is focused on an individual word—the word ‘measured’. Will the word ‘measured’ appear or not appear? It becomes a formula.

CHAIR—So it is more exciting.

Mr Macfarlane—This is fun for the screen jockeys, but I do not really believe myself that it is serious communication. That is why I have never been enthusiastic about doing it.

Dr EMERSON—The statement of monetary policy issued on the 13th again describes Australia’s export performance as ‘disappointing’, ‘lacklustre’ and ‘slow to eventuate’. I am referring to volumes, obviously not to record prices. Australia’s foreign liabilities as a share of

GDP is around 60 per cent now and David Gruen from Treasury has done some calculations that indicate that to even stabilise it at 60 per cent we would need to run trade surpluses of between a half and three-quarters of a percentage point of GDP.

We have now had 45 successive monthly trade deficits, despite the best mineral prices since 1974. How do you imagine that we can stabilise that ratio? By running trade surpluses, it seems to me that there are just two possible ways: one is that the exchange rate adjusts and falls dramatically. That would then add a lot to the price of tradable goods, and we know that nontradables are growing in price at about 3½ per cent per annum, which it would seem may force the Reserve Bank’s hand to increase interest rates if such a depreciation occurred. The other way is to slow imports through a recession. Neither of those seems to be a particularly attractive option. So how could we stabilise that liabilities to GDP ratio by running trade surpluses when we have had 45 successive deficits?

Mr Macfarlane—The thing that threw me there slightly when you were speaking is that I think you switched from current account to trade. I think the paper that you referred to was saying that a three per cent current account deficit would stabilise it, and that is consistent with a small trade surplus. So you are referring to the trade surplus?

Dr EMERSON—Yes.

Mr Macfarlane—That paper said that, to stabilise it where it is, the current account deficit would have to go down from six to three, which does not sound quite as dramatic as saying we have to go into surplus.

Dr EMERSON—No, but we need to go into trade surplus.

Mr Macfarlane—Yes, I know. You are right. Arithmetically, you are quite right. You would have to go from six per cent to three per cent current account deficit if you wanted to stabilise it. This is extremely similar to the debate in the US. The exchange rate is free to go down whenever it wants to go down. We have a floating exchange rate. If people were really disturbed about the current account deficit and the external liabilities and they thought that we were heading for an unsustainable situation, then the exchange rate would plunge. But of course it is not plunging. Similarly in the US, which also has a current account deficit of six per cent of GDP, everyone has been predicting for five years that the US dollar was going to plunge, but it has not; it is about average. So the exchange rate option is always there. If the market decides that it thinks it is unsustainable, it does not have to wait for the government to introduce a policy; it would simply manifest itself in a fall in the exchange rate. The fact that it is not falling suggests that most people do not think it is unsustainable. The alternative you suggested was that you have a squeeze on the economy to get the economy to slow down sharply.

Dr EMERSON—That is not one I favour.

Mr Macfarlane—No, I know. I think the reason you do not favour it—no-one favours it—is that the immediate costs of that would be very, very substantial in order to achieve an objective that no-one has really agreed upon. No-one knows whether the current level of liabilities is unsustainable at all. In fact, the market is saying it is not unsustainable. So it is not surprising that the government is not going to rush out and crunch the economy to achieve something which neither it nor the majority of observers regard as an unsustainable situation that requires drastic remedial action.

Dr EMERSON—We do have huge imbalances building up in the external accounts and also in domestic demand, so something will give at some stage. I think it is not really for you to make these decisions, but some preparation needs to be made rather than waiting for a calamitous collapse in the exchange rate. But my next question is in relation to the May statement of monetary policy from last year. Allow me to read the last bit. It is about the outlook for interest rates at that time, and it says:

Based on previous cyclical experience, it would be surprising if interest rates did not have to increase further at some stage of the current expansion.

There you were talking about the prospect of further interest rate rises. That was after the March rise. That never happened, and what did intervene was petrol prices went through the roof. Did petrol prices do essentially the same job as, say, a quarter percentage point increase in interest rates and, if we did not have those petrol prices, would that pressure to increase interest rates have built up?

Mr Macfarlane—I have not thought of this in this way before, so I am not quite sure how to answer that. On one level, the rise in petrol prices caused inflation to go up faster than expected, so some people would say, far from meaning you did not have to put up interest rates, that it may mean there was even greater reason to put up interest rates.

Dr EMERSON—But it also slowed the economy.

Mr Macfarlane—It also slowed the economy, but we are not confident that it slowed the economy by very much at all. We know the economy has slowed, but I do not think that was a major player in it. If you look around the world, every economy has had to face this big increase in oil prices and very few of them have slowed. In fact, most of them have chugged along at the same rate as before or have actually picked up. It seems to me that the contractionary effect of the rise in oil prices has actually been remarkably small in virtually all countries. I think that is the case here too. The fact that we slowed was not due to the rise in oil prices. I think the fact that we slowed was the turnaround in the housing cycle and the wealth effects of the fact that house prices were no longer going up and that households decided they wanted to improve their balance sheets and become more cautious. That is the biggest single reason why the Australian economy slowed and we were very happy that consumption stopped growing at an unsustainable rate and got back to growing at a quite modest rate.

Dr EMERSON—My final question, in the absence of the member for Hunter, is that you have spoken about the three influences that are creating extra inflationary pressure. There are private sector forecasts for a budget surplus in the coming budget of around $15 billion. What sort of challenge does that pose if there were then, out of those surpluses, very substantial income tax cuts? Would that provide extra stimulus and therefore extra pressure on the Reserve Bank to increase interest rates?

Mr Macfarlane—This is another question that comes up regularly and so it should. We have had a pattern in recent years in Australia where, as everyone knows, during the course of the year we have become aware that the surplus is going to be bigger than was thought likely at the beginning of the year. So, as we approach the end of the financial year and the May budget is brought down, either expenditure increases or tax cuts are made so that the surplus is reduced going forward. The question is: in the act of doing this, which is an expansionary act of fiscal policy, does that make it difficult for monetary policy? My answer has always been and still will be that it has not actually made it difficult for us because the surplus over the last five or six years has roughly been somewhere between a half and 1½ per cent of GDP and it has not moved very much in that range. It is the big movement year to year which would be difficult for us, if there were a very big movement year to year, but what we are really seeing and what you are describing is almost a seasonal pattern in fiscal policy. As we go through the year, surprise surprise, taxes are stronger than we thought which is exerting a contractionary influence through the year and then you get to nearly the end of the year and you give it back again. So you have an expansionary impact right at the end of the year. So you really have a within-year seasonal swing in fiscal policy, but from year to year all the years look very similar. From our perspective, it is the fiscal impact, which is the change from year to year, which could potentially cause us difficulties but which has not because the change has been relatively small. Despite the fact that it is talked about frequently in the financial press and amongst economists, it has never figured as an important part of our deliberations on monetary policy.

Dr EMERSON—So we could afford tax reform?

Mr Macfarlane—It is a question of how much. Yes, clearly we can afford some changes to taxes or to expenditure or some mix of the two. It is simply a matter of what is the right amount.

Mr SOMLYAY—In your statement on page 8, you said that the CPI figure was a little below expectations. You mentioned that the global disinflationary forces are stronger than expected. Can you expand on that? What are the global disinflationary forces that cause that?

Mr Macfarlane—There are two types, and they are closely related. In financial markets, there is a huge amount of savings in some countries relative to their investment. In other words, they are producing a lot more than they are actually consuming. China is the obvious example, but the whole of Asia—Japan has been like that too, for some time. There is what is sometimes referred to as a savings glut. There is more of it around than we thought, and this is putting downward pressure on the interest rates that the markets determine. But, at the same time, this business of producing more than you are consuming brings us back, principally, to China and the fact that, as they bring on stream a massive supply of extremely cheap labour and find more and more ways of producing standard products, internationally traded manufactured goods, cheaper and cheaper, this puts downward pressure on everyone’s CPI around the world. That is what we think of as global disinflationary pressure. If you really want to symbolise it in the simplest way, in one word, the word is China.

Mr TANNER—I want to ask about two matters. The first is the appointment of Robert Gerard to the Reserve Bank board. Were you consulted about the appointment, and, if so, what view did you express to the Treasurer? In Mr Gerard’s continuing role as a member of the board, is his obligation to notify a change of financial circumstances or interests to you or to the Treasurer? Finally, do you believe that the events of the end of last year reveal any flaws in the process of board appointments that we should be turning our attention to?

Mr Macfarlane—On the first question, the Treasurer phoned me and told me that he intended to appoint Rob Gerard to the board vacancy. I had not heard of Mr Gerard and therefore was not in a position to express an opinion. The Treasurer described him to be a manufacturer from South Australia. I knew that the Treasurer had for a long time been seeking to find a manufacturer for the next board vacancy, so it did not surprise me that he had, it seemed, killed two birds with one stone—found a manufacturer and found someone from outside New South Wales and Victoria—so I did not express a view or oppose the appointment. That is the answer to the first question. You had better ask me the second question again.

Mr TANNER—You have effectively answered the second question, which was: what opinion did you express? The third one was: as a board member, is his responsibility to report a change of circumstances—that is, make a financial declaration—to you or to the Treasurer?

Mr Macfarlane—Normally, if it is a conflict of interest and they want a judgment on a conflict of interest, a board member will report it to me. In my understanding of the case you refer to, there was not a change of situation. That situation existed before the appointment and it did not change during the period of the appointment, so I do not think it is relevant.

Mr TANNER—The final point I was raising is whether, in your view, these matters expose any flaws in the board appointment process that we ought to be giving consideration to.

Mr Macfarlane—I think it did expose a problem—there is not much doubt about that—in that someone was appointed who had engaged in some behaviour such that, had it been known, they would not have been appointed. So I think that that does show up a flaw. I am not quite sure how you overcome that particular thing, given the confidentiality of the tax system. As to whether we should adopt a very different way of making board appointments, it is always up to people to come up with suggestions. I am not totally wedded to this one, but I would point out that, in the time I have been in this position, there have been 20 appointments made to the Reserve Bank board or the Payments System Board, including reappointments. Nineteen of them have been excellent and one caused intense controversy.

Mr TANNER—My second question relates to the dog that didn’t bark.

CHAIR—You had four questions then, I thought, but anyway.

Mr TANNER—Thanks for that. I am pleased to see that you can count. My second question relates to the dog that didn’t bark. You will note that the Howard government, in its advocacy for its Work Choices package, has routinely claimed that, once implemented, this will lead to a significant improvement in productivity, better employment, better wages and so forth. We all know the rhetoric. It is interesting that, in spite of the fact that this system is due to come into effect in the next few months, in your statement of monetary policy there is not a single reference to that and the major impact that it is alleged it will have on the Australian economy. And, even more, in your statement this morning there is a sentence that reads: ‘So, in the absence of a significant lift in trend productivity growth, we should expect to see annual GDP growth rates mainly in the twos and threes.’ As a not totally disinterested observer, it seems to me that the bank is essentially saying that Work Choices will have a negligible impact on productivity and Australia’s economy or economic performance. How do you respond to that?

Mr Macfarlane—I think we are talking about time frames here. My understanding is that, even though it has been passed by the House and the Senate, it has not been implemented. My understanding is also that it is going to be subjected to High Court challenge. So I do not think everyone out there in the community is going to be rushing to exploit it until some of these things are resolved. Finally, if these things are resolved, then by and large businesses will start to take advantage of it, but only on a timetable dictated by when their current enterprise bargains run out. And most of these are two- or three-year bargains. For the forecasting horizon that we look over, which is a year or 18 months, it is hard to see that it would have an impact. That is why we have not specifically taken it into account in our forecasts.

Mr TANNER—The reference to annual GDP growth rates mainly in the twos and threes strikes me as being plural, not singular. You seem to be projecting a bit further forward in that observation than just 12 or 18 months.

Mr Macfarlane—All our forecasts—all our observations—really only cover a period of 12 or 18 months, unless we specifically say, ‘Now let’s turn to some other issues, some medium-term issues.’ The previous two waves of industrial relations reform, one brought out by the previous government and one by this government, had a big impact, but, even if people started acting on them immediately, the effects took a long time to show through. And I think it will be even more so with this one, because I do not think that people will be able to act on it immediately. I think there will be a long lag before people are confident that they have overcome all the hurdles—and then, because enterprise bargains have become longer and longer as time has gone by, an additional lag before people can act on it.

Mr CIOBO—On that last point, I take it that effectively what you are saying is this. Over the medium term you have said that past liberalisation of labour forces had, I think you said, a significant effect, and presumably a positive one. I gather from your comments that the uncertainty from the High Court challenge and the fact that there is uncertainty from the alternative government would have an impact over the medium to long term on whether Australia enjoys the economic benefits from an increasingly liberalised labour force. Is that correct?

Mr Macfarlane—I am not an expert on industrial relations, but I certainly do think that the previous two reforms had a very beneficial impact, and I would expect that this one in time would have a beneficial impact.

Mr CIOBO—Can I also clarify some issues that were raised by the deputy chair. With respect to your comments on tax reform being affordable, it seems to me that comments that you have made both today and in the past have indicated that measured reform is appropriate in terms of fiscal policy but that perhaps complete structural reform of fiscal policy that would result in significant loosening would have an adverse impact on your role with respect to monetary policy. Is that correct?

Mr Macfarlane—The point I have made in the past is that there have been periods in our history, over the last 20 or 30 years, where there have been very big swings in the fiscal position, such as from balance to minus three per cent in the year. Swings of that magnitude would have an impact on the economy and, hence, on how we decided monetary policy.

Mr CIOBO—Such as the abolition of certain rates rather than increases in thresholds, for example.

Mr Macfarlane—I am not going to be drawn into which particular aspects of tax reform should or should not be concentrated on, because I am not a tax expert. All I am saying is that I think the practice over recent years of making sure that we do not have big swings in fiscal policy limits the resources available for whatever particular tax changes or expenditure changes the government may be envisaging.

Mr CIOBO—I invite you to comment on Al Greenspan’s legacy and the appointment of Dr Ben Bernanke to the US Fed and whether or not you have any views on likely changes that may have on US federal policy.

Mr Macfarlane—I think Dr Greenspan was an excellent chairman and I expect that Ben Bernanke will be also. I think it was a very sensible choice. I was impressed by the fact that the Bush administration made the decision very early. I thought it was a very good choice. I think Ben Bernanke will be very similar to Greenspan. People are trying to draw distinctions between them but, to date, the only distinction they have really come up with is that Bernanke in the past been has been an advocate of a numerical inflation targeting regime whereas Greenspan adopted what I would call an implicit inflation targeting regime. However, I think the differences will be minor. With the US Federal Reserve Board being so sound and so deep and Bernanke being an orthodox economist of the Greenspan school, I do not think you will notice any difference.

Mr CIOBO—You made reference today to the Australian economy being one of the best performances in the developed world and we are enjoying our 15th year of expansion. We have seen a number of reforms instituted by this government, including labour market reform and economic reform. At the last hearings, you made some comments on areas in which you felt there could be scope for additional reform. Recently, for example, the Queensland state government made some announcements with respect to their rail operations. I invite you to comment on the scope for additional reform and perhaps whether some of the moves we have seen at a state level are of concern.

Mr Macfarlane—I have made the point on a number of occasions that, whilst monetary policy can take a lot of credit for the stability of the expansion, for a long period the lift in productivity was nothing to do with monetary policy; it was to do with structural and microeconomic reform. To me, there were about five components to this, which have been occurring over the last 15 years: tariff reduction, financial deregulation, privatisation, labour market reform and competition policy. I think all five have been extremely important.

I think we want to see further reform. We will be constantly evaluating our institutions to decide whether or not they really are first best. We have one reform, which has been achieved but not implemented yet, which is the third phase of labour market reform. My understanding from the recent COAG meeting is that there was agreement on some significant further improvements in competition policy—in particular, with land transport pricing, the national energy market and coordination of infrastructure regulation—between the ACCC and the various state regulators.

I think there are many things still to be done. I do not profess to be an expert, but I think there are many things that we can continue to do. It seems to me that some things are difficult to do because of popular reaction; other things seem to be difficult to do because of federal-state rivalries. Everything is difficult to do because, in nearly every form of reform, there are some losers and some winners and the losers are usually concentrated and very vocal and the winners are widespread and do not say much. That bedevils the whole process—but you would know more about that than I would, because you see it from the political perspective. However, I think there are still a number of things that we can do, which I have just mentioned. I do not want to go and add anything to that list because I do not profess to be an expert.

Ms GRIERSON—I would just like to finish off some of those points on IR. Given that the IR reforms are seen as an economic reform and, therefore, influencing productivity, was the Reserve Bank given modelling or projections on that issue from Treasury or from the government?

Mr Macfarlane—No.

Ms GRIERSON—I think the other worry for people watching the situation play out is the distribution of productivity, the ratio between wages and profit. You will be aware that wages are declining and profit is escalating very much in terms of productivity and GDP. We are looking at Work Choices legislation that perhaps will push the wages share even lower and therefore a requirement for income support for low income-earners becomes greater. Do you have a view on this distribution of profit and wages?

Mr Macfarlane—I am a little bit out of touch with the figures on this.

Ms GRIERSON—A recent report said profit is 27 per cent of GDP, up from 16 per cent in the 1970s, and wages, greater than 60 per cent in the 1970s, are now down to about 53 per cent of GDP.

Mr Macfarlane—The reason I say I am out of touch with the figures—I know the raw figures—is that there are complications due to privatisations, things which were in the government sector now being in private profits, and there are also complications in the movements between self-employed and employed. Malcolm, do you know any more about that? My understanding is that effects like that have tended to make the profit share rise more than, in a sense, the real profit share has risen.

Dr Edey—That is right. The tendency towards incorporation is raising the profit share. I think also, if you take the 1970s as a base, you are coming off a period where the labour share was unusually high. But where we are at the moment, even allowing for all those things, the profit share is fairly high but part of what is driving that is the increase in the terms of trade which provides a big boost to profits. That is able to happen alongside rising real wages at the same time, so it does not mean that workers are worse off.

Ms GRIERSON—Housing prices and housing affordability is always an issue on the eastern coast. Recent OECD reports said that our Australian property prices are overvalued, unlike our share market, and noted that the proportion of residential investors buying properties had doubled in the past decade. Could you comment on the impact that halving capital gains tax may have had on the property market?

Mr Macfarlane—The OECD report, in fact, was even more extreme. It said that Australian house prices are the most overvalued in the world. The way they calculated it was by basing it on the ratio between price and rents—in other words, the earning yield on property. As you know, the earning yield on property in Australia is incredibly low. It is about two or 2½ per cent, because prices have been driven up so much and rents have hardly changed. I am aware of that piece of research. The question is: what effect did the halving of capital gains tax have? I think it encouraged more speculation in investor housing. There is not much doubt.

Ms GRIERSON—So are we in a situation where there is an interplay between the halving of capital gains tax plus the first home owners grant maintaining higher prices in this market?

Mr Macfarlane—No, I do not think it is a continuous process. The evidence for that is that they have stopped rising on average throughout Australia, but I think it did contribute to the big lift that occurred over the past five or six years. I think the halving of capital gains tax was not specifically directed at housing at all; it was a decision that was taken at a time when share prices around the world were going up but not in Australia, where everyone was saying Australia was an old economy—this is when our exchange rate was plunging and everything else. The decision was taken in that environment and it was probably more directed towards investment in new technology industries and all the rest. But, in the event, with the historic propensity of Australians to buy houses, a lot of it ended up going into investor housing.

Ms GRIERSON—A recent report says that Australia has the highest household debt to asset ratio of any wealthy nation. Obviously, that translates to vulnerability for people when interest rates rise. There have been some suggestions that movements in interest rates should be finetuned and it should sometimes be less than 25 points.

Mr Macfarlane—The fact that Australian households do carry so much debt is obviously something that influences us in our decisions on monetary policy. It is one of the reasons why this tightening cycle has been more drawn out than previous tightening cycles. We started in the middle of 2002 and here we are approaching the middle of 2006 and we have had five small tightenings. It is something we do take into account. Should we move from 25 basis points to something lower? I am not very enthusiastic about that at all. I think it would be better to just have a single 25 basis point one rather than two 12.5 basis point ones.

Ms GRIERSON—You said you would not comment on tax policy, but given that debt vulnerability what do you think would be the best influence to have: savings increased, debt reduced or consumption—the way that people can benefit from that and employ any tax cuts? Would you like to comment on what you would see happening in terms of contribution tax going out of superannuation or a tax cut to wages?

Mr Macfarlane—I said I was not going to comment on tax policy; that is a tax, so I am not going to comment on it.

Ms GRIERSON—We always live in hope!

CHAIR—I invite Mr Keenan to ask some questions.

Mr KEENAN—I wanted to take up the point about the demand for labour. Certainly, everywhere we go around the country people are constantly telling us they cannot find skilled or unskilled labour. One thing the government has been doing to rectify that is using the immigration system judiciously to bring people in to try and increase labour supply, which is something that the labour movement naturally has concerns about because it wants to keep the supply of labour restricted. What are the consequences for the economy if we cannot get more people in? In Western Australia we are hearing a lot of anecdotal reports that projects are going on the shelf because they just cannot get workers. What will the ultimate consequences be for the economy if we cannot rectify this undersupply of labour?

Mr Macfarlane—The ultimate consequence is that some production just does not get done. This is the sort of thing that does happen, not just here but in other countries, when you get to very high levels of capacity utilisation. In our case, not only are we at high levels of capacity utilisation but also we have a skewed demand in that an inordinate amount of the demand is for expansion of resource capacity. That is why it is not surprising that a Western Australian is bringing this question up. The answer is: some things do not get done, which is disappointing.

Mr KEENAN—I would like to take up my colleagues' point about housing affordability. I saw the OECD report and it certainly does not seem to gel anecdotally with what we see if we travel to other parts of the world, where housing does seem to be a lot more expensive—though I understand your point about that being related to rental yields. A lot of people point to the tax system as creating that, but how much does it have to do with the supply of land and with planning policies?

Mr Macfarlane—This is an interesting subject. I think that the average price of houses in a big city like Sydney or Melbourne—the average price of houses—is not much influenced by planning restrictions, because a new house 30 or 40 kilometres from the centre is not going to be competing with Malvern in Melbourne or Double Bay in Sydney. And no matter how much you expand them, it is not going to have an effect on the prices of those inner areas. There is, however, a body of evidence that suggests that, for the first home buyer who wishes to live in an outer suburb on the fringe of the city, planning has increased the entry price a good deal. There are a number of people in Australia who are pushing this view and I think there is international evidence for it. So I think that a lot of the planning restrictions have affected the entry price for the first home buyer, but I do not think they have affected the average price for all the houses in a big city.

Mr KEENAN—Finally, I just wanted to get you to expand on the comment in your opening remarks about the decline in banks' lending standards. You point to practices that are eroding those standards. What specific practices are you talking about?

Mr Macfarlane—At a general level, I am talking about the increasing proportion of housing loans that are not supported by documentation, the increasing proportion of housing loans that go to sub-prime borrowers—that is, people with an impaired credit history—and the fact that the allowable proportion of a person's income to be devoted to debt servicing, which used to be about 30 per cent, has gone up, in some cases, to 50 per cent. But there are a lot more specific issues. Glenn, do you want to add anything to that?

Mr Stevens—The proportion of loans being offered now where there is little or no documentation is probably about 10 per cent of new loans—that is up from 5 per cent a few years ago. At one stage, low-doc loans were, basically, exclusively available from specialist lenders, but they are becoming much more widespread now and some of the mainstream lenders are offering those. Some banks are taking a second look at borrowers that they had previously rejected. As for the additional interest rate on a low-doc loan that you would once have paid, that margin is actually coming down quite substantially. You can get loans without a deposit. In a number of instances now, some banks are raising the maximum loan to value ratio. As Ian said, the extent of the leverage they are allowing the borrower to take is going up. So I do not think that there is much doubt that is happening.

I should say as well that it is not just banks—this is a phenomenon across the whole lending spectrum. I suspect that these lenders would say, in defending that, that when they do their risk metrics—when they look back at loan loss experience—this business is a good idea, because loan losses have been very low and, indeed, historically in Australia the experience with mortgages has been extremely favourable. But of course the problem is that these backward-looking metrics analysing risk are looking at a period of 10 or 15 years which has been particularly benign for the economy and for housing borrowers in particular. So the real question is whether that is a very good guide at all to the riskiness of this business; arguably, it will not be in the future. So I think that will be quite an important issue in how all this unfolds in the years ahead.

Mr KEENAN—Can I follow that up. A lot of these products you have mentioned have been a legitimate response to consumer demand for people who do not necessarily fit into a particular box the bank might like to create. Is there evidence that this is actually a problem or are you foreshadowing what might be a problem in the future?

Mr Stevens—I think the evidence of it being a serious problem is not yet in. There is certainly some pick-up in loan arrears. That is more noticeable in the case of some of these more fringe-type loans. Those arrears as yet remain low. Hopefully, that will still be the case as time goes by. But there is no doubt that people who once would never have hoped to get a loan can get one much more easily now. I do not think this is going to bring down a bank—far from it as best as we can tell from all the work that examines this. The banks are so strong that even if loss experience goes up a lot, they would not even go close to losing their solvency position. But I think in a situation where more marginal households are getting into a lot more debt, they are taking on a risk. If something adverse happens to their circumstances, they are much more likely to be finding themselves in distress than would otherwise have been the case. At the moment, that is a small group of people but, as time goes on, if it grows, that potentially can have some macroeconomic implications were we to suffer an adverse shock from abroad.

CHAIR—It was reported in the press on the weekend that there has been a rapid increase in the rate of mortgagee sales of homes. One statistic that was provided by a particular real estate agent in Sydney was that now one in 10 are mortgagee sales and that they were one in 40. That is perhaps in isolated areas in Sydney, but it does fall into line with—

Mr Stevens—There has been some pick up in re-possessions of property. Some figures were quoted in the paper the other day that, on the surface, looked a bit alarming. With those particular numbers that is of course re-possessions, or applications for re-possessions, of all types of property. It is not just people being put out of a house onto the street. It would include industrial properties and even vacant land. There was probably some exaggeration in a bit of that reporting. But there is some increase in loan arrears measured in the banks and in the securitised debts as well. There is some of that going on. It remains low, but it has gone up to some extent.

Mr SOMLYAY—You stated that these are matters in which prudential regulators are taking a strong interest. Is there an implied threat in that to the financial institutions?

Mr Macfarlane—I think APRA is constantly quizzing the banks and the other deposit-taking institutions that it supervises on these practices. They have made changes over recent years to toughen them up a bit but, the thing is, APRA's job in some sense is to make sure that the banks do not take risks that are bad enough to cause the bank to fail. These things are not going to cause a bank to fail but we think that they are risky for the economy as a whole. The classic example is that we now have advertising on television encouraging people who have no money at all to borrow 100 per cent for a house. Historically, one of the reasons why Australians have got such a great record for continuing to pay their mortgage, even when times are tough, is that they own part of the house. But if you own none of the house, how much commitment are you going to have if things turn tough? This is an example of where future behaviour may be nothing like the behaviour over the estimation period that the banks are looking at when they are calculating their risks. But, again, it is a risk to the community; it is not really a risk to the solvency of the banks.

Dr EMERSON—We talked earlier about the building up of external imbalances and financial imbalances. Isn't this an example of financial imbalances building up; and aren't they similar to or perhaps worse than the lending practices around 1988 and 1989, which led to the recession in 1990, when banks were trying to grab and maintain market share and basically lent to anyone who wanted a loan and even to some who did not?

Mr Macfarlane—There are some similarities, I agree, with the analogy; but it is nothing like the scale that occurred then, which brought down two of the biggest banks—which happened to be state owned banks—the biggest building society et cetera. It has some similarities but the scale is nowhere near as big. The quality of the supervision and the prudential rules are much more robust than they were then.

CHAIR—Before we go to a break, we will have two questions from students of Erindale College.

Kyle Hallett—It is definitely great to be here today. Mr Macfarlane, you pointed out that Australia has been able to avoid global economic recessions, as was the case in 2001, despite our continued efforts to globalise. What characteristics of the Australian economy do you credit with making this possible?

Mr Macfarlane—The main characteristic was that we did not build up the imbalances that give you the vulnerability. For example, a major reason for the recession in the US and a lot of European countries was the huge increase in share prices that preceded it. This affected not only households, but things like insurance companies and a lot of financial institutions. When these collapsed, I think that was a major contributor to what turned out to be a reasonably mild recession but a recession nevertheless. So we did not have that problem and, at that point, we still did not really have a housing problem either. So we managed to get through the best part of 10 years without any obvious imbalance that I think created a vulnerability. It is true that we had current account deficits, but I do not think they create the same sorts of imbalances and the same sorts of vulnerabilities as asset price booms do.

Ned Hmeidan—Mr Macfarlane, increased oil prices have been putting upward pressure on inflation and interest rates, but cheaper Chinese imports are having an opposite effect. Which factor do you see as having a greater effect on inflation levels in the Australian economy in the short- to medium-term future?

Mr Macfarlane—I think that, in the short term, oil prices had a bigger short-term effect, if you want to measure it over the last year or 18 months. In the medium term, it is the other—the worldwide reduction in the prices of internationally traded manufactured goods, and China is the biggest single reason behind that.

Proceedings suspended from 11.38 am to 11.53 am

Mr FITZGIBBON—I think most of the important issues have been raised with the governor. I thank him and his colleagues for their responses. I thought I might move on to an entirely different area, and that is the question of governance. I think the governor is very well placed to share some views on these issues given his length of tenure and the possibility that, in the not too distant future, he may be going to do some more fishing, or whatever he does in his periods of relaxation. Governor, this is not designed to cast aspersions on any member of the board, including appointed board members, but I have heard some concerns expressed about the time between when board members are given your recommendation, which is accepted almost 100 per cent of the time, and when the final decision is made. Of course during that period before the decision is announced a fair bit of communication takes place between the board and board members, and that information is not necessarily only in the hands of the board members.

My first question is: can you see an opportunity to improve the integrity of that system in any way? The second question is about the appointment of board members themselves. I am tempted to ask if you have a view about whether having such a structure is the most appropriate, or whether having a small board of economic experts, such as we see in operation in the US, is a better model. There is a view around the parliament that there might be some merit in this committee meeting in camera, in a confidential sense, and vetting the people who are under consideration for employment on the Reserve Bank board. This would ensure that those people who are appointed have the highest level of integrity we would expect of people presiding over decisions which involve access to such important and sensitive financial information.

Mr Macfarlane—I think there are about three questions there. The first one, I think, is a very simple one: why don’t we announce our decision immediately at the end of our board meeting rather than wait until the next day? We have discussed this at length. Our non-executive board members do not like the delay. They would just like it to be done immediately. There are complications, and a lot of the complications have certainly been associated with the money market. Essentially, our practice is to announce it when the money market starts rather than have something change halfway through a money market day. We may be right; we may be wrong, but at the end of the day we come down with that view. One of the reasons is that, even if we got rid of that little bit of risk—the risk of someone knowing something overnight—there is already a lot of risk in the system in the sense that the board papers go out to board members on a Thursday night. The recommendation is there, and nearly always the recommendation is accepted so, in a sense, the moment a board member receives the board paper, they are actually in receipt of inside information and we rely on their honesty to never act on it. To the best of my knowledge, no-one has ever acted on it—even though there were some rumours many years ago about someone, and I think they were totally unfounded. We have not changed our system.

If we could find a practical way of doing the first point, we would do it, but it would still only take out a small amount of the fact that there are people who would have inside knowledge—of course, not just in Sydney, as the board paper comes to Canberra and various people in Treasury would read it, and the Treasurer would know about it. There is, as far as we can see, no reasonable way of eliminating that risk without also eliminating the sort of briefing that people need to make a decision. That was the first question.

The second one was on the composition of the board, the fact that our board is not a group of specialist economists and that we have a majority of non-executive directors who come from various walks of life. I have spoken on this at length before. I concede that it is an unusual model. Most countries that have a board have people on it who are normally specialist economists but most of these people are nearly also always full-time. So they are not really a board in the sense that a company board is a board; they are really like a group of full-time professionals who get together. I might, just as an aside, mention that the model that is often held out as being superior to ours and that people suggest we might imitate is the Bank of England model, but the Bank of England model, surprisingly, has moved slightly in our direction in that the last two people who have been appointed by being made deputy governors of the Bank of England were people who were senior civil servants—but not people of particular expertise in monetary economics or even economics in general. So the last two people who have been appointed to the Monetary Policy Committee of the Bank of England have been non-specialist economists; they have been civil servants. But we go one step further and have people from the private sector. What it suggests is that countries are still experimenting with the composition of their board or their monetary policy committee.

The final question you asked was: would it be improved if a committee such as this could interview prospective board members? That is done in the UK, but my understanding is that that committee does not have a right of veto; it just has the capacity to interview people. As far as I am concerned, that is entirely a decision for the government, the parliament or whoever has strong views on that. I would neither support it nor oppose it; I could live with it.

Mr FITZGIBBON—Do you accept that a non-executive member of the board could have a competitive advantage over those with whom they compete, due to some of the information they acquire as a member of the Reserve Bank board?

Mr Macfarlane—I do not think they have a competitive advantage in the sense that they have a better knowledge of monetary policy: when interest rates are going to rise or fall. I do not think they would have a better knowledge than a well-informed economist who has no connection with the Reserve Bank. They appreciate the general economic briefing they get and they find that very valuable. But, apart from that period when they receive the board paper and the board decision, I do not think they have any better understanding of how monetary policy will evolve over the rest of the year than, for example, a well-informed economist who follows the economy, the indicators and the debate and who is totally independent of the Reserve Bank.

Mr FITZGIBBON—I was not suggesting that they would have a better knowledge of where monetary policy is going, but I think the information supplied—which forms the basis of your decision or recommendation on monetary policy—is significant.

Mr Stevens—The board gets a briefing from Malcolm, Ric and co. This material closely overlaps with that, so the briefing is a very high-quality briefing. Virtually all of that material ends up in the public domain every three months anyway, so it is there for whoever is interested enough to read it.

CHAIR—We have another half an hour left for questions on the economy overall—perhaps one question per member—and then we will move on to the payment system. People might want to jump in with respect to raising themes in the discussion. If I could kick it off with the labour market. On page 8 you refer to the labour market as being relatively tight. A concern that you had at the hearing before last concerned the tightness in labour availability and that seems to have eased somewhat. Page 36 of your statement on monetary policy states:

Over the year to the December quarter, employment growth was strongest—at around 30 per cent—in the mining industry, while the largest fall was in wholesale trade.

We hear regular anecdotes about the tight labour market and skills shortages and how these are pushing up wages growth. How does the bank reconcile the fact that this wage pressure does not seem to be flowing through to inflation? Can we conclude that firms are absorbing these higher costs into their bottom line; if so, how sustainable is this margin squeeze?

Dr Edey—The first point to make is that, even though the labour market is tight, the pick-up we have seen in wage growth has been fairly modest so far. Probably the best indicator of that is the wage price index which a year ago was growing at 3½ per cent. It is now growing at 4.2 per cent. So there is a noticeable pick-up there. It is not huge at this stage. Why hasn’t it gone up more? I think what is important here is the flexibility of the labour market compared with how it was at a similar stage in earlier business cycles. We now do not see the sort of automatic flowthrough of wage pressures in one sector across the whole economy that we saw earlier.

CHAIR—It is the dual economy effect. You can have this 30 per cent growth in employment in the mining sector—which is predominantly Western Australia—and it can be contained at the border.

Dr Edey—Under the old principle of comparative wage justice, it used to be possible for a sector that faced concentrated wage pressure to get a big increase and then achieve automatic flow-through through the industrial courts to other parts of the economy, but that does not happen now. I think that is an important structural change in the labour market, so that is one important part of the answer. The other issue is the flow-through of the wage pressures that we have had through to prices. I think what is happening is there is some pressure on margins because of the competitive nature of the retailing industry, for example; but I think also what we are seeing are the disinflationary pressures coming from around the world that were talked about earlier putting a cap on the ability to pass on cost increases.

Dr EMERSON—I would like to ask a question about productivity growth, taking a point that Lindsay Tanner made in referring to your statement today, which is:

... in the absence of a significant lift in trend productivity growth, we should expect to see annual GDP growth rates mainly in the 2s and 3s ...

Governor, you also listed five major sources of productivity growth to various deregulation exercises—financial market, labour market, privatisation, national competition policy. Then if we have a quick look at the *Intergenerational report* it forecasts or assumes that productivity growth from 2005 will slip back, from an average during that very strong period of 2.05 per cent, to 1.75 per cent and, based on that, per capita GDP from 2010 onwards would grow at the slowest rate of growth since the decade of the Great Depression. So that is at 1.75 per cent, but since early 2004 it has been negative. It seems to me that this is a pretty sombre outlook for GDP growth, where you are saying that in the absence of strong productivity growth we are going to be looking at GDP growth in 2s and 3s—but in fact it has been negative, so not only not strong but negative. Isn't there a compelling case for a new economic reform agenda perhaps to finish off some unfinished business but also to look at new areas such as investment in human capital and other productivity raising measures?

Mr Macfarlane—I suppose I have to agree. In the long run the economy can only grow as fast as the multiplicand of the growth of the working age population, the participation rate and the rate of increase of labour productivity. For various reasons we think the greater growth of the working age population is going to slow, so that of itself means you look at a lower potential growth rate that puts the pressure back on productivity. I certainly do think that we have to constantly be looking for ways of increasing productivity. Some of them sound easier than others. The problem is that with a lot of the things, particularly competition policy, you actually have to take a few privileges away from people, and that becomes a bit difficult to do. There are other ways of doing things which do not take any privileges away from people, like, for example, improved education, skill education and things like that. The limitation there is really the budgetary cost of doing it. But we should be looking at all these sorts of things and we should probably still have the same enthusiasm for it that we had five years ago, 10 years ago or 20 years ago. I have mentioned some of the things where I think things could be done, but I do not profess to be an expert in this area. Others know a lot more than I do, but I am aware of the fact that sometimes it is very difficult because there are a lot of vested interests who are not particularly interested in the nation's productivity; they are interested in their own personal rewards.

Dr EMERSON—How would labour productivity grow out of Work Choices when we have got very high levels of employment? It means that those who are brought into employment—if any—as a result of Work Choices would not be the most productive workers in the country.

Mr Macfarlane—I think what it does is increase employment. It is possible to conceive of situations where, by bringing more people into employment, some of them not having particularly high productivity, the nation's output goes up and the nation's employment goes up but its productivity does not go up. But that is not an argument not to do it.

Mr Stevens—Its income per head has gone up though.

Mr Macfarlane—Yes, even if its income per worker has not changed.

Dr EMERSON—I understand that, but you just said productivity does not go up.

Mr Macfarlane—That is income per worker. But there is still a case that, if you wanted to have the highest productivity, you would find the highest productivity industry and throw out the rest of the economy. You could have the highest average productivity.

Dr EMERSON—We understand that, but the government is arguing that Work Choices will lift productivity growth. I think arithmetically it cannot.

Mr Macfarlane—I do not want to get involved in that. There may be dead-weight losses that it can get rid of but I think you are right to say that, to the extent that it draws people into employment who otherwise would not have a job, that of itself does not lift productivity, but it does lift national income per head.

Mr CIOBO—One commentator made reference to the fact that he thought Reserve Bank monetary policy had been too loose in the early part of this decade, which in part played a role in the housing price boom that we saw. I seek your comments on that.

Mr Macfarlane—I do not agree that it was too loose. This is the period we were referring to where world interest rates reached their lowest level for a couple of centuries. We were one of the few countries that did not participate in that extremely low level of interest rates. In fact, we were the only developed country that did not lower interest rates in 2003. Every other country did. There was a period where our interest rates, following the world recession of 2001, were lower than they had been, but by international standards they were still very high and that was a period when the Australian dollar went from 60c to 80c in the space of little more than a year. It was also a period where we maintained low inflation.

I think it is very hard to say that monetary policy was too loose, unless you get into this business of saying that monetary policy has got multiple objectives. For example if you wanted to, after the event, you could say, ‘Look at the current account deficit. It’s too large; that’s a failure of monetary policy.’ You can say, ‘House prices went up; that’s a failure of monetary policy.’ But the fact is that you cannot run a monetary policy that has multiple objectives like that. You have to run a monetary policy and explain a monetary policy and get community support and government support—and we have support—for a monetary policy which is based on inflation targeting. We have achieved what we set out to do and what we agreed to do with the government. That does not mean that things like house prices and wealth effects and asset prices are ignored. They are included insofar as they are going to have an effect on economic activity or on inflation. So they do get into our assessment process but they do not get a second additional guernsey as a second ultimate objective. They come in through their influence on inflation. They do not get counted twice. For that reason I think it is not legitimate to point to either something like asset prices or the current account and say, ‘That’s a monetary policy failure.’

Mr CIOBO—Thank you.

Mr FITZGIBBON—I want to return to the concept of a so-called dual economy. Can I suggest that it does place some limits on the board in the setting of monetary policy in that you are dealing with two very different economies in a sense? Does it invite a more innovative approach on the fiscal side from government? Does it raise questions about the way in which we distribute money back to the states? There has been a lot of debate about Grants Commission formulas and of course the distribution of the GST. It would seem obvious that the current arrangement could be fuelling growth in the resource states and suppressing growth in those states in the south-east.

Mr Macfarlane—Yes, it is the case that if you transfer fiscal funds from the slow-growing parts to the fast-growing parts, you will increase the disparity in growth rates. I do not think anyone could deny that. But just how you go about reforming the Commonwealth Grants Commission I do not know. I do not know the history of it. I suppose the other thing they might say is that some of this spurt is cyclical and it could be reversed in three years time. But certainly, at the moment, there does not seem to be a logical case for taking the taxpayers' money from New South Wales and Victoria and redistributing some of it to Western Australia and Queensland.

Ms GRIERSON—I was wondering if you could give an update, for the general public in particular, on the investigations into fraudulent emails and the impact of that attempted high-tech crime?

Mr Macfarlane—It actually turned out to be a very minor event. The commercial banks had been affected first. Basically, someone put up an email saying: 'We the Reserve Bank are trying to remedy financial crime. So that we can do that, please give us your EFTPOS card number and all your banking details.' I was quite impressed that, virtually the moment the thing went up on the screen, we were inundated with emails and phone calls saying, 'Look what someone is doing!' We immediately put out a statement saying that it was fraudulent, and we got the Federal Police and the New South Wales Police to do the same. We have not heard of any repercussions from it. We do not know whether anyone was fooled into giving their information and, if they did give their information, whether the perpetrators of this fraud were able to withdraw funds from their bank accounts. We have not heard anything back, which suggests to us that it was probably not a very successful fraud.

Ms GRIERSON—Thank goodness!

Mr TANNER—Mr Macfarlane, I want to ask about the bank's holdings and sale of gold. Some years ago, the bank sold a very substantial quantity of gold into the market, as did one or two other central banks. Without unduly emphasising hindsight—it is a wonderful thing—I am wondering how much more money we would have got out of it if we had held onto that amount of gold until now. Are there any regrets or lessons to be learnt from what has occurred?

Mr Macfarlane—First of all, let me make it clear that the decision we made to sell that gold was not because we were trying to maximise profits. The decision was made for two reasons: firstly, we did not think gold gave us any diversification benefits—that is, the country was full of gold, we are a big exporter and we did not think it made sense for us, when we had the opportunity to diversify our reserves, to have much of our reserves in gold.

Mr TANNER—So it is a risk issue?

Mr Macfarlane—There is a second issue which is related to that, which is that you rarely need to dip into your reserves in order to sell them, but the occasions when you do need to dip into them are when your exchange rate is plunging, which is usually when commodity prices are falling, which is usually when the gold price is at a cyclical low. So our conclusion was that, almost certainly, if we ever needed to make use of that gold, we would be forced to sell it at its low point. As you would be aware, the gold price has very big swings and, along with other commodity prices, it has swung up again recently. If you do the calculations over the last nine years, we were ahead for 8¾ years of the last nine years. At the moment, because of the spike in gold, we are behind, but who knows what it is going to be like in two, three or 20 years time, which is the horizon we want to look over.

CHAIR—I would like to follow up with a question on the share market. I noticed that on page 5 of your statement you note that the Australian share market has behaved quite differently from the global market over the past decade. You say that, along with the Canadian share market, it is the only major market that is currently above earlier peaks. From the point of view of the economy, the local equities market has recently touched a series of highs, thanks in part to very strong growth in the commodity sector. Does the RBA believe there is an equity market wealth effect for households to rival the housing market wealth effect and, if so, can we expect to see household spending rebound this year in the wake of the share market’s gain? How are households likely to cope if the share market falls?

Mr Macfarlane—All the international evidence is that the wealth effect from shares is much smaller than the wealth effect from housing. Our share market has been going up pretty consistently for the last three years—hasn’t it, Ric?

Mr Battellino—Yes.

Mr Macfarlane—It is gone up 20 per cent a year or so over the last three years, and that is in a period where the household sector has actually moved into a period of restraint. Consumption has slowed right down from the earlier very high rates. So my guess is that the effect from the share market onto household spending is actually quite small.

CHAIR—Do you think it is sustainable? You have said in the statement that it is the only major market that is currently above earlier peak levels, so do you think that that is sustainable?

Mr Macfarlane—I do not think the fact that we are above peak levels makes us vulnerable. It really just means we did not have a bubble like everyone else did in 2000.

Dr EMERSON—I think you referred earlier to the smoothness of the transition from Alan Greenspan to the new governor of the Federal Reserve in the United States. Given where we are in the business cycle and the imbalances and so on that I have spoken to, would you see and could you outline any advantages in a smooth transition when, sadly, you do decide to move on to perhaps another senior member in the Reserve Bank?

Mr Macfarlane—Yes, I would. I think a smooth transition is very important. But I do not think I can really go much further than that. I think the fact that Bernanke was a prominent member of the Federal Reserve Board—he was a governor of the Federal Reserve Board—gave him a credibility that helped when he was appointed, and I think it will be a very smooth transition.

Ms GRIERSON—Just out of curiosity, has the Reserve Bank been consulted or expressed a view to government on the Future Fund or given advice on that sort of challenge?

Mr Macfarlane—In the period leading up to Future Fund, yes, we were consulted—that was quite a long process—on a number of occasions. We presented our views. I think we might have even presented more than one view because, as people's opinion was evolving and as the fiscal position was evolving, we were certainly consulted. Now we are consulted at a technical level, in the sense that the funds that will form the foundation of the Future Fund are actually on deposit with the Reserve Bank at the moment. So we are constantly in touch with the AOFM about those sorts of matters.

Ms GRIERSON—Is there any quantification in the difference between holding them with the Reserve Bank and the potential of holding them in a Future Fund and therefore investing them in different ways?

Mr Macfarlane—I think in the long run, if they are invested in a broad range of financial assets, they should earn a higher but more variable return than being invested with us, because invested with us they are essentially earning the short-term interest rates. It is a mixture. How would you best describe it?

Mr Battellino—It is a combination of overnight deposits and bank bills and the sort of interest rate they are getting on average on that.

Ms GRIERSON—Which is what at the moment?

Mr Battellino—They are getting about 5½ per cent. Of course, with the yield curve being so flat, even if you held the 10-year bond, you would not get any more. It is a very constant yield curve.

Ms GRIERSON—Did you advise on the sort of composition of the investments, or is that someone else's role?

Mr Macfarlane—That will be someone else's role. We may well be asked, because there are some very big issues there. We will probably be asked but, to the best of my knowledge, there has been no decision taken on the composition of the investments that will be held in the Future Fund.

Dr EMERSON—I wanted to make a quick point and ask a question about New Zealand's labour market. My understanding is that the New Zealand economy is slowing and is likely to slow further, yet we have intense skill shortages here. Given the ease of migration from New Zealand to Australia, can you envisage increased migration of working people from New Zealand to Australia to create a greater equilibrium in the labour market there and to address labour market shortages that are occurring here in the context of New Zealand slowing down and us still going strongly in demand for labour?

Mr Macfarlane—Yes. I think this is a bigger issue for them than it is for us, because these flows are very big relative to the size of the New Zealand economy but they are small relative to the size of our economy. I could envisage it happening if the New Zealand economy slowed down a lot, but at the moment New Zealand still has a very low unemployment rate. So it is something that might happen in the future, as opposed to something that could be happening now.

CHAIR—Can I ask a question as someone who lives in New South Wales—we both do. They have certainly been moving much slower than other states. We discussed the comparative slowness of the economy last time. Do you see them moving out of this in the short term, and what are the key areas that you think they should be addressing? Obviously they do not have the advantages of the commodity boom which Queensland and Western Australia have experienced.

Mr Macfarlane—Who is the ‘they’ you are referring to? You said ‘should they do this or should they do that’.

CHAIR—The government of New South Wales.

Mr Macfarlane—I do not have any plans for any state government other than to try and administer the state as efficiently as possible.

Mr SOMLYAY—It was a nice try, though.

CHAIR—But do you see some fundamental problems?

Dr EMERSON—‘Could you bag out on the New South Wales state government?’ I think he is asking you.

Mr TANNER—Tell us about the cross-city tunnel, for example.

Ms GRIERSON—It is just a soft target.

Mr Macfarlane—I do not know that I can add anything, Bruce. I do not have a plan.

CHAIR—Could I move on to questions about the fact that household borrowing in Australia may have bottomed out and may even have started to rise. I notice that home finance approvals rose nearly one per cent in December alone. Is this something you are comfortable with? Home loans are still growing at an annual rate of more than 12 per cent, which is much faster than growth in the economy.

Mr Macfarlane—We do not know what the household credit will plateau out at. We do not know what the right rate of credit growth is. It is actually higher than you think, in the sense that you have to finance all the new homes that are being built. Basically, when houses change hands, the buyer inevitably has to make more use of credit than the seller. The seller has usually already been living in it for some time and they have reduced their debt, and the buyer usually has more debt. These two facts mean that household credit growth, even in quiet periods, is still going to be substantial. So we do not know whether 12 per cent is something to worry about or not. On the other issue of whether it is picking up, there is a little bit of evidence. If it were to pick up substantially, yes, that would be a concern, but at the moment the evidence is still reasonably slight.

CHAIR—The final question from me is about a study the RBA released last year of the impact of home equity withdrawal on consumer spending. One conclusion the report seems to draw is that home equity withdrawal played a smaller role in inflating household spending than many people believed, and a fall in house prices therefore may not have had the severe impact on household spending some had predicted. In the wake of this study, is the bank comfortable with falling house prices in the larger cities? What sort of impact on household spending is this likely to have?

Mr Macfarlane—Last time we were before this committee we said we were going to release a study and we gave you some ideas of roughly what we thought it was going to say. The study has been released and it indicated that most of the household equity withdrawal actually went into other financial assets. It did not go into spending, which was quite encouraging. That means that the economy is not as sensitive to swings and roundabouts in house prices as it might have been. It is still sensitive to some extent, but not to an extreme extent.

Do we feel comfortable with what is happening in the housing market? By and large, yes. The fact that, on average, over the country, house prices are flat gives us some encouragement. The fact that they are falling in some places is not cause for alarm, in our view, particularly if they are falling in the places where they previously had the biggest boom. That seems to me perfectly normal.

CHAIR—Does anyone have one final burning question on the economy before we move to the payments system?

Mr TANNER—In the report, the graph showing debt service ratio for households is a little scary. I am interested in your view as to what extent that is creating a very broadly based exposure that potentially, if we do have an external economic shock, could magnify the impact of that shock.

Mr Macfarlane—We have spoken about that in the past and we think that, of itself, will not bring a turnaround. But if the economy does experience some negative shock, the classic one being significant increases in unemployment or even households that lose a high-paying job and have to take a lower paying job, some of those households would be very vulnerable, given the huge amounts of debt servicing. This is a thing we have drawn attention to repeatedly.

Mr TANNER—You are not worried that it appears to be getting worse?

Mr Macfarlane—It is hard for it not to get worse if the amount of housing credit is growing faster than income. Even with a constant interest rate, it means it goes up. It is not something that we are particularly comfortable with, but I am not sure that we can do anything about it.

CHAIR—Moving to the payments system—and I will be glad for my colleagues to join in the questioning—you would be aware that this committee has had some concerns about a reduction in interchange fees. What we see is that there may have been some distortions in the market as a result. Do you have any further evidence to show that reduction interchange fees, and the consequent reduction in merchant service fees, has been passed on to consumers? And what has been the benefit to cardholders in relation to reductions in annual fees, rewards et cetera?

Mr Macfarlane—The first one is an old chestnut and I will explain it again. Like just about everything that happens in competition policy, the costs are concentrated and the rewards are very widely spread. It turns out that the initial saving of $580 million to the bank's customers is one-tenth of one per cent of consumption expenditure and even less than that of total expenditure—and cards are used for things other than consumption. So, if you have the CPI going up by 2½ per cent and you have all sorts of big influences—labour costs going up or down, oil prices going up or down and taxes going this way and that—and another little thing moving by less than one-tenth of one per cent, the chance of you being able to break down the increase in the CPI and separately identify something as small as that is nil. So we cannot prove it.

On the other hand, every businessman I have ever spoken to in my life has always said that, if you cause business costs to go up, prices will go up and, if you do something or other that leads business costs to going down, prices will go down. I cannot believe this market is any different from all the other markets that I have heard about over all those years. So I would find it inconceivable if there were not some long-run downward pressure on prices that comes from that, but I cannot prove it.

The next thing you asked was: 'What benefit have we got from the fall in the interchange fee?' Of course, there are a lot of benefits, because we have to look at all the customers of banks, not just the cardholders. We have to look at the merchants, the people who buy things who do not have a card and the people who buy things who do have a card. I think the loudest squawks will be coming from the people who buy things with a credit card, because some of those are now having to pay for something which previously other people paid for—the other people being consumers in general and merchants, because of the high interchange fee. That interchange fee, which was paid to the card issuers, enabled them to provide certain things like point systems and rewards. That interchange fee has now been effectively halved.

I draw your attention to one of the effects of halving that interchange fee. For many years when I used to come to this committee, people would ask me the standard question: 'Why is the interest rate on a credit card so high? Why is it 17 per cent?' Year after year, I used to get asked that question and my answer was always the same: 'I don't know.' It is only in the last two years, since our reforms, that there is now serious competition in that area of credit cards. There is serious competition there because the interchange fee is lowered and there is not enough money to cross-subsidise through point systems to compete through reward schemes. A number of card issuers then asked themselves: 'Why don't we do something that was unthinkable before? Let's try and find a better product for those people who actually borrow from their credit cards.' So we have had a whole range of new credit cards issued with interest rates as low as 8.99 per cent. That was unthinkable until we cut the interchange fee. There are a whole range of users of credit cards who formerly were utterly ignored and who are now finding the benefits of competition.

Mr FITZGIBBON—While still on the issue of interchange fees, I want to turn the focus to foreign ATMs. You will be aware of the recent controversy when Westpac dramatically increased the charge. I understand that, in recent years, you have been sitting back, hoping that the industry can sort this issue out itself. It has obviously not been able to do so. A range of suggestions have come forward from industry but no agreement has been reached, and it appears to me that it will not be reached. Isn't it time now to designate that area of regulation?

Mr Macfarlane—This is a big question. It is interesting that with some areas that you designate you immediately get taken to court. People say: 'How dare you! You're overregulating us.' In other areas people are saying, 'Why don't you designate?' I do not think we are at that point yet. There are two parts to your question. The first one is: why do all banks charge the customer a much higher fee for using a foreign ATM than the foreign ATM owner charges the bank? It is not something that we can do anything about, because that is a relationship between the banks and their customers, and that is where we hope competition will work. The other issue, which is a bigger issue, is: should we move away from our current system of interchange fees and own ATMs and foreign ATMs? That is the one that we have been wrestling with for a long time. I will ask Phil to give you an update on what the current state of play is.

Dr Lowe—For some years the industry has been looking at whether it could introduce a direct charging model—that is, the ATM owner directly charges the person withdrawing the cash. For a while there seemed to be an emerging consensus that such a model could work in Australia. But, towards the end of last year, all the large banks decided they did not want to proceed down that route. So they wrote to the Reserve Bank asking whether we could give some direction as to what we saw as a sensible way forward. We did that towards the end of last year, and we made three points to them.

The first point we made was that we would like to see access arrangements liberalised, because it is still quite hard for a new ATM owner to come in and establish direct connections with the existing banks. So we asked for access to be liberalised. Secondly, we asked that they remove any technical constraints that prevented an ATM owner from directly charging their customers. Thirdly, we asked them to make sure that any interchange fee arrangements could not be used to preclude new entrants. We made those three points to them at the end of last year, and we have asked them to go back and look at whether they can respond to those three requests. The working group have re-formed and they are currently looking at those.

As Ian said, we are not at the point where we feel like we should rush in and regulate. The Payment Systems (Regulation) Act was really set up under a co-regulatory approach, where we were only supposed to use these powers when we did not think a solution was possible. And while the industry has been working for quite a long time here, I think a solution still is possible and we want to give them more time to do that.

Mr FITZGIBBON—I would say that, like most in this room, I am all for less regulation rather than more. But these charges are so far above marginal costs it is just inexplicable, so something is not right in the market. The big lever you have available to you, of course, is the threat of designation. You have been very patient in this regard; we have been talking about this now for years. The banks keep coming back to you, wanting to know why they cannot do it, and asking if you would consider some other form of assistance. I think they have had a long, long time to sort it out themselves, and a bit more heavy-handedness would not go astray.

Mr Macfarlane—Even if we were to designate them, though, it is not clear to me that we could make them change a fee like that. The only fee that we have changed is a collectively set fee, where the market was not operating. But, as for the fee that a bank charges its customer, we have never changed one of those fees, and we do not have the power to do that. We are relying on competition there. We can’t just step in and do that; we do not have the powers.

Mr FITZGIBBON—My point again is that the threat of designation would surely be a great incentive for the bank to—

Mr Macfarlane—Yes, but I think we could only designate if we thought that the whole system had seriously failed and we wanted to move to an alternative system, which would be a direct charging system. Whilst there are certain attractions in that, I think that the experience of it in the UK certainly has led the banks to think they do not want to go down that path. But even if we did go down that path, and we thought that was a better system, we still could not tell a bank what fee it could put on a customer taking money out of its ATM.

Mr CIOBO—Governor, as you know, I have a specific interest in the regulation permitting changing of fees for credit cards. I accept, in large part, your comments about there perhaps being intangible economic benefit that flows to the economy as a whole from lower merchant fees, and from the competition that has been generated out of Visa and MasterCard being required to compete, and the influence of the interchange fee on that. My concern, however, revolves around what appears to me to be a competitive neutrality problem with respect to Amex and Diners Club relative to Visa and MasterCard. That is a point I have touched upon previously. In addition, my concern lay with, for example, large organisations such as Qantas who typically, I suspect, do the largest proportion of their business via credit card payments. I am interested in your comments, given that Dr Lowe said in a speech back in, I think it was, early 2005 that:

> ... the credit card reforms have not affected everyone equally. Those that benefited most from the previous arrangements were those who used credit cards heavily and paid off the balance before the due date. More often than not these people tended to be those on high incomes. The reforms have undoubtedly made credit cards relatively less attractive for these people.

I have some questions, and you can comment on them as you see fit. Are we seeing the migration of transactors, as I think they are referred to in the industry, from the regulated part of the credit card scheme across to cobranded cards, three-party schemes? You talk about household credit levels; are we seeing an increase in credit being provided to those on lower incomes as a result of increased competition in the marketplace for the other schemes? And are we seeing large merchants—such as Qantas, for example—effectively enjoying a windfall as a result of decreased merchant fees and a desire to use the more expensive payment system because it is additional revenue to them?

Mr Macfarlane—There is a number of questions there, and I will have a go at them. The first one is the non-neutrality. I know some of you have raised this before, and a lot of people in the banks raise it. They say that the three-party schemes, Amex and Diners, have enjoyed an advantage. Before we actually started publishing figures on this, they led us to believe there has been this really big change of market share. We then started collecting the figures. There has been a change in market share, but it is an extremely small one.

Mr CIOBO—Can I just clarify. Is the market share by volume or by value or both?

Dr Lowe—We have both. We have a graph here of market share by volume.

Mr Macfarlane—The blue line at the top is Visa and MasterCard, and the red one at the bottom is Amex and Diners. It is true that at one point when two banks switched over to issuing cobranded products with Amex their market share went up from about 14 per cent to 16 per cent. But that is really the be-all and end-all of the story. There has been a change of market share, but it has been a very small one, and it is not an ongoing one. That is the answer to the first question.

Mr CIOBO—Is also does represent a one-seventh increase for that particular market.

Mr Macfarlane—That is right. If it went from 0.1 to 0.2 per cent, would it be a 100 per cent increase in market share, if you calculated it that way?

Mr CIOBO—You cannot discount it.

CHAIR—Can we have the graph that you have just provided as an exhibit for today's hearing?

Mr Macfarlane—Yes, you can. Put it in the report if you can. There was another question, which was quite an intriguing one, which seemed to imply that by making credit available to lower income people at more moderate interest rates we were encouraging the growth of household debt. I think that is rather a tenuous argument. Would you like us to go back to making them pay 17 per cent?

Mr CIOBO—No. I am just questioning. There has been community concern about bank lending practices with respect to credit cards. I am just wondering—I am not implying anything—whether that is the factor.

Mr Macfarlane—I think the community concern about credit cards is that so many credit cards are being handed out. You walk down the concourse of the airport and there are people lining up to give you credit cards. They are advertised extensively on television. I walk down Martin Place and there are people trying to get me to sign up to credit cards. The reason behind this is that the issuing of credit cards is still phenomenally profitable. That is why there are so many credit cards being pushed out. You do not see people standing at airports trying to offer you an EFTPOS card. You do not see advertising on television for EFTPOS. It is always for credit cards because credit cards is where the big money is. The Australian public, bless their hearts, actually like to have EFTPOS cards. Despite the fact that they are not promoted, there is still a very large number of people who like to have control of their finances and do not want to slip into debt. There is a clear public demand for EFTPOS cards, and as a result the banking sector have to provide them. But they provide them without enthusiasm. What the banking sector will provide is credit cards. They want you to use credit cards because credit cards are much more profitable to them.

CHAIR—At the CBA annual general meeting didn't they comment on the fact that the returns from credit cards had fallen? I think that was recent, in the past two days.

Mr Macfarlane—That would be the flow-through from the cut in the interchange fee.

Mr FITZGIBBON—There are lots of examples where absolutely viable and profitable small firms with low debt servicing ratios are unable to secure an extension on their loan to deal with a small short-term cash flow problem. Yet the same small business person, having arrived home at night, will find an offer in the mail for a credit card with a $10,000 credit limit on it. It is crazy. I am not suggesting there is anything you can do about it, but it is a problem.

CHAIR—I think Mr Ciobo has not quite finished yet.

Mr CIOBO—I am happy to wait, also, for a response to the merchant question.

Mr Macfarlane—About Qantas?

Mr CIOBO—I was citing that as an example.

Mr Macfarlane—As you know, we are in favour of merchants being able to pass the banking fees on to the person who uses the credit card. We are strongly in favour of it. We think they are acting in the national interest when they do that.

Mr CIOBO—My question revolves around a business that obtains the vast bulk of its revenue that way. The point of the payment system is that it is largely substitutable. But when you have a business such as Qantas, which, I understand, obtains a large proportion of its revenue through credit cards, do you not have a situation where, effectively, given there is an opportunity for substitution, they obtain a windfall gain by being able to generate sales down the more-expensive-for-the-consumer path and thereby enjoy the benefits that flow from that?

Mr TANNER—More competition in aviation would fix that.

Mr Macfarlane—My understanding is that what they are doing is, if you pay, as a lot of people do, with a credit card—you are right to say that a lot of people pay for airfares with credit cards—their bank charges them a fee for that and they are passing that fee on to the customer. If you turn up there personally you could pay with an EFTPOS card if you wanted to. If you really wanted to, you could pay with cash. You could probably write a cheque. But if you choose the payment system which is the most expensive for the merchant, the merchant wants to pass that back to you. That is a principle which we support.

Mr CIOBO—But it is not really happening, is it? That is the reason why, I would suggest to you, we see Qantas launching a cobranded AMEX credit card—because it is in their interests to do so. Are you suggesting it is merely coincidental?

Mr Macfarlane—I do not know why Qantas launched a cobranded credit card.

Mr CIOBO—It is a three-party scheme. I think it ties into the point that I am making that three-party schemes enjoy a distinct regulatory advantage. The only rebuttal I have heard thus far is that we only saw a two per cent increase in global terms in market share and therefore there is not a concern. I am putting to you that there should be a concern because, although there may only have been a two per cent increase in market share for three-party schemes, they enjoy a significant competitive advantage over four-party schemes.

Mr Macfarlane—What I am putting to you is that the general benefit to the community, because of the increased competition which has been engendered by this regulation, far outweighs changes in market share of that size. It would be nice if you did not have any, but I think the benefits to the community as a whole and to banks' customers as a whole far outweigh that.

Ms GRIERSON—Governor, with $3.4 billion collected last year from bank fees, bank fees is a hot topic for customers. You rightly point out that the Reserve Bank's intervention has brought down interest rates on credit cards in some ways. But there was an anomaly recently where the Commonwealth Bank had a windfall from putting them up without any interest rate increase at all. Would you have a comment on that? If that behaviour continued, would the Reserve Bank be interested in responding?

Mr Macfarlane—We do not have any power over the ordinary fees that a bank charges its customers. The only ones we have any power over are the ones that involve the payment system and only then if they are collectively set rather than set as a result of competition between providers. That is that all I can say on that subject, I am afraid.

Ms GRIERSON—I cannot explain that anomaly either.

Mr CIOBO—What would you foreshadow would be the scope of the 2007 review and how might it be conducted, if it is appropriate to do so?

Mr Macfarlane—I am not sure that I know at this stage. We are having enough trouble with the things we are currently doing at the moment. Is there anything you can say on that, Phil?

Dr Lowe—When the credit card interchange fee reforms were introduced we indicated we would do a review of how things had gone four or five years afterwards. That is what we are planning to do. That process will start in the second half of next year, but we do not have any firm proposals or details about how that is going to work at this stage.

CHAIR—On the whole question of the three-party system and the banks being involved in issuing Amex cards and Diners cards, with the banks now becoming involved in the process, isn't that a reason for looking at them being regulated in the same way? There is angst in the market, as you know. We hear from the lobbyists on a regular basis. It would appear that there are differentials, especially now you have the banks involved in issuing these cards. Are there now grounds for saying, 'Okay, if you are having three-party systems, it is something we should look at in terms of regulation'?

Mr Macfarlane—The only comment I can make before I hand over to Phil is that this is happening everywhere. It is not just an Australian thing that banks are doing co-branded products with Amex; it is happening in other countries as well, so it is not a result of what we have done. It is something that is happening worldwide.

CHAIR—Where it is happening big-time, of course, is in the US, where they have not had the impact in terms of the interchange fees.

Mr Macfarlane—But I still think that it would be very difficult to regulate a fee that a financial institution charges its customers. I do not know whether you can add anything to that, Phil.

Dr Lowe—I think the American Express business is quite different to the Visa and MasterCard businesses. In Visa and MasterCard, there is a centrally set interchange free; in the American Express arrangements with the banks, those fees are bilaterally negotiated. We looked very closely at the arguments for regulating them. One of the considerations that has led us not to regulate them is that, if we were to cut the interchange fee American Express pays one of these banks, there are many other financial flows that can occur. There are a lot of marketing payments and product support payments that go between the various entities here. Our concern was that, if we were to cut the interchange part of that payment, these fees could flow into other forms of payment. What we would end up having to do is regulate the totality of the payments between the various parties of the payment system, including product support and marketing payments. I do not think anyone thinks that is a sensible idea.

The different nature of the regulatory response is very much a function of the different nature of the businesses. What we have really tried to do with American Express is to make sure that, when the merchants are negotiating with American Express, they are not tied down by restrictions imposed on them by American Express. So American Express have agreed to allow surcharging and to allow customers to be steered towards other payment instruments. That is the margin where competition actually works here because, if merchants have more bargaining power with American Express, they will end up with lower merchant service fees and ultimately there will be lower fees back to the issuing banks.

Mr Macfarlane—Isn't there a technical argument which says that, with the four-party scheme, it is the interchange fee that determines the merchant service fee?

Dr Lowe—That is true.

Mr Macfarlane—With these co-branded things that banks are doing with American Express, the merchant service fee is the thing that starts it all and then the bank and Amex just argue about how that is split up. So you would have to go straight to the merchant service fee. There really is no point in trying to determine which part is called interchange fee and which part is not, for the reasons that Phil was alluding to.

CHAIR—You are probably aware that we intend to do some more work on that during the year. We will see where we come to on that. I want to thank you, Governor, for your participation today and your willingness to take questions and your openness to this marathon session. We really appreciate you coming here to Canberra. There is some pressure from Mr Ciobo to have our next committee hearing on the Gold Coast. We will see whether he succeeds when it goes to the vote. Thank you again, and I thank the other members that have come today from the Reserve Bank.

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

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 12.59 pm