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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: Review of the RBA Annual Report 1998-99

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Members: Mr Hawker *(Chair)*, Mr Albanese, Ms Burke, Ms Gambaro, Mrs Hull, Mr Latham, Mr Pyne, Mr Somlyay, Dr Southcott and Mr Wilton

Members in attendance: Mr Albanese, Ms Burke, Mr Hawker, Mr Latham, Mr Pyne, Mr Somlyay and Dr Southcott

Terms of reference for the inquiry:

Review of the Reserve Bank of Australia's annual report 1997-98.

WITNESSES

Committee met at 10.02 a.m.

CHAIR—The committee has unfortunately had a depletion in numbers. Two are unwell and one was fogged in, until half an hour ago, in New South Wales and has not been able to make it. Apart from that, I declare open the public hearing of the House of Representatives Economics, Finance and Public Administration Committee. I welcome representatives from the Reserve Bank, members of the public and the media and especially the schools that are represented. The committee is pleased to have in attendance today so many senior economics students from schools nearby. In fact, we are slightly embarrassed because the response was overwhelming and we have had to turn some away. But this is the first time we have had such an attendance and I welcome the students. I am sure you will find this morning's proceedings very interesting, and you will certainly see a section of the parliament at work as well as seeing the Governor of the Reserve Bank and his two deputies.

Ms BURKE—Mr Chairman, perhaps I could break in and particularly welcome my old alma mata, my old high school, which is here today.

CHAIR—In 1996 the government and the Reserve Bank agreed that twice a year the governor would appear before the committee to answer questions about the conduct of monetary policy and issues outlined in the bank's latest semi-annual statement. The Reserve Bank's annual report for 1998-99 and the first annual report of the Reserve Bank's Payments System Board also form part of the discussion.

It is most appropriate to have this hearing today. There has been intense public interest focused around the four recent interest rate rises over the last six months, and the impact that that will have on inflation in the coming year. The committee will also be examining the effect of changes in the United States interest rates on the rates in Australia. The Reserve Bank is at the centre of all the efforts to deal with these issues.

Today we will have the hearing divided into two parts. The first part will be looking at monetary policy, and the second will be covering other matters relating to the bank's responsibilities.

[10.04 a.m.]

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia

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

STEVENS, Mr Glenn Robert, Assistant Governor (Economic), Reserve Bank of Australia

CHAIR—Welcome. I remind you that the evidence that you give at this public hearing is considered to be part of the proceedings of parliament. I therefore remind you that any attempt to mislead the committee is a very serious matter and could amount to a contempt. Mr Macfarlane, I am sure that you would like to make an opening statement.

Mr Macfarlane—Yes, I will, as I normally do. I start off by reaffirming what a pleasure it is to be here in Melbourne again for our regular half-yearly appearance before this committee. We met in February and we touched on monetary policy, but that meeting was mainly about the reform of the international monetary system. On this occasion, we will no doubt have a lot more time to spend on monetary policy than we did on that occasion.

I would start the meeting in the traditional way by reviewing the forecasts I gave to the committee last November, and then outlining our current views on likely developments over the year ahead. Last November, with half a year's data available, I said that we expected GDP growth through 1999 to be 3½ per cent. In the event, it was 4.3 per cent, which continued our record of expecting a modest slowdown that did not arrive. I also said that we expected growth to be four per cent in the year to June 2000. On present indications, this still looks likely, even though the rate will probably dip below four per cent in the year to March. Of course, it will be more difficult than usual to read the true trends this year because of the shifts in expenditure as a result of the introduction of the GST and also the boost from the Olympics.

Most monthly indicators of economic activity point to a slowing so far in 2000. However, it is too early to know whether this merely represents the slowdown in domestic demand that we have all been waiting for and that we have had built into our forecasts for some time, or whether it represents something bigger—a significant slowing in GDP. Our judgment is that we are seeing mainly the former; namely, a change in the composition of GDP growth. In other words, the slowing in private domestic demand, which is undoubtedly occurring, will largely be offset by the boost we are getting from net exports and we will soon get from fiscal policy.

While we expect some slowdown in GDP in the sense that we do not expect to be able to repeat the 4½ per cent per annum average that we had over 1997, 1998 and 1999, we still see quite solid growth ahead. We have no quibble with the sorts of figures that were contained in the budget papers, showing growth in GDP in the fiscal year 2000-2001 of 3¾ per cent. Such an outcome would be a quite remarkable achievement compared with the record of the past three decades. But I will return to that subject later.

On inflation, in November at our last hearing we forecast that the CPI would rise by two per cent in the year to December 1999 and by 2¾ per cent in the year to June 2000. We got a little closer to the mark in these forecasts, although the outcome for the year to December was 1.8 per cent rather than two, but we now think that the figure for the year to June 2000 will be a little higher at three per cent rather than 2¾. Some of the increase in the CPI is due to temporary factors, so the three per cent for the CPI corresponds to about 2½ per cent for underlying inflation. Thus, we have finished the period when inflation was below the bottom of our range, a period which lasted longer than any of us expected, and we have moved back to where the CPI is near the top of our range but partly due to temporary factors.

Where do we go from now? This will be a particularly hard year to judge given that, for at least a year ahead, the year-ended figure for the CPI will be obscured by the once-off effect of the introduction of the GST and the abolition of the wholesale sales tax. At present we feel that, once all the dust has settled—in other words, once we have gone through that year and once we are well into the year 2001-2002—the mostly likely outcome for inflation will probably be in the two per cent to three per cent target range, and probably in the upper half. As usual, there is a very large margin of uncertainty attached to that. But the adjustments to monetary policy which have been made over the past six or seven months give us more confidence that inflation should be contained.

I would like to move away from the short term, as I have finished with that, and turn to the medium term. Most developments in monetary policy can only be understood fully in the medium-term context—although, by necessity, most commentary concerns short periods such as month to month, in line with Reserve Bank board meetings, or even shorter periods such as day-to-day, reflecting the deadlines of the daily press.

I will start by restating the logic of the inflation targeting framework, which is the underpinning of our whole medium-term approach. We have an inflation target that says inflation should average somewhere between two per cent and three per cent in the medium to long run, or over the cycle—or whatever wording you prefer. We accept that at times it will be outside this range. But, if we think that is going to happen more than briefly, it calls for adjustments to monetary policy which will return inflation to the target and then keep it there. We have based our monetary policy on this framework not because we only care about inflation but because we think it will give us the best result for the whole economy in the long run. In particular, if applied sensibly, it will enable the economy’s average growth rate to reflect its potential growth rate and, therefore, deliver the maximum sustainable increase in employment and living standards.

We have already seen nine years of expansion, if we count the current quarter, with growth averaging more than four per cent. That is a considerably longer expansion than we were able to achieve in the 1970s or 1980s, and there is every prospect that the expansion will continue for a good deal longer. For the first time in my working life, Australia in the 1990s has come near the top of the decade growth rates among developed countries. In the 1990s we grew faster than the United States. Among the developed countries, only Ireland recorded faster growth, and there were some very special factors behind that.

This growth occurred at a time when our inflation rate averaged about 2¼ per cent—a good deal lower than in earlier decades and comparable with international standards. There was also less variability in the growth rate from year to year than in earlier expansions, although some variability is inevitable. During this expansion we have had annual growth rates of more than five per cent and less than three per cent, yet the fundamental momentum of the expansion has remained intact. I think the system has proved itself to be a very good one, and I am confident that it is the best way to ensure that monetary policy makes sense in the medium term.

It is also worth noting that, during the course of the expansion, we have had one complete cycle in interest rates—rises in 1994, then falls in 1996 to 1998. These played their part in sustaining the expansion. The increase in official interest rates of 125 basis points that has occurred over the past seven months should be seen in this context. For the present expansion to continue as long as possible, monetary policy has to be adjusted as circumstances change. The economy has been undergoing a shift from a period when inflation was below the target to one where it was going to be in the target range. Without policy adjustment, there was the prospect that it would in time rise above the desired range. Until relatively recently, in fact, we were receiving information on economic activity that indicated the economy could even have been accelerating beyond the 4½ per cent growth that had prevailed over the 1997 to 1999 period.

From our perspective, the decisions to raise interest rates were relatively straightforward ones. The situation is not as straightforward now. Signs of a near-term acceleration in growth have gone. As discussed earlier, there are now signs of slowing domestic demand, some of which may be in response to the tightenings in monetary policy that have already occurred. Other things being equal, this should be helpful in containing inflationary pressures. Other developments—principally, the lower exchange rate—will act in an expansionary direction and potentially put upward pressure on inflation. It will be a difficult time for reading and forecasting the domestic economy, and all this will take place against the back-drop of an international economy dominated by the uncertainty of the unfolding events in the United States.

Markets as always will be looking for guidance. The more thoughtful will appreciate the complexity of the situation; the less thoughtful will be expecting to be told the formula that we are using. Unfortunately, there is no formula other than the guiding principle of the inflation targeting regime. This means that we will be assessing the outlook for inflation as judged by the factors which form the basis of our forward looking approach to monetary policy.

Growth in demand and output and the extent to which that places pressure on the economy’s capacity are clearly important. We judge this by examining all the available monthly and quarterly time series data on economic activity, including those which give the impression of intangible factors like confidence. We monitor trends in commodity prices, wholesale prices and wages, as well as the CPI and the various measures of underlying inflation derived from it. The wages data may be particularly important in the year ahead, given the difficulties in interpreting the price indices. We have to allow for structural change, such as the increased competitive pressure in goods markets. This has been an important ingredient in maintaining downward pressure on many prices and should be helpful in negotiating the introduction of the GST. Inflation expectations are important because it is the anticipation of price rises that drives many decisions. We also need to consider the financial side of the economy: the expansion of credit, trends in asset markets and the extent of risks which may be building up there.

We then complement this essentially domestic analysis with an appreciation of what is happening in the international environment in which Australian producers and consumers make their decisions. We cannot afford to ignore the world price level: world demand, world interest rates, or the variable which connects both of them to the Australian economy—the exchange rate. Changes in the price of imports in foreign currency terms can have a large impact on domestic inflation, as shown by the OPEC oil price rises of the 1970s. The recent oil price increases demonstrate the same principle on a much smaller scale. Rises in a range of raw material prices driven mostly by global trends are also having an impact on the cost of producing goods in Australia. In the opposite direction, the subdued world price environment of 1997 and 1998 helped contain any inflationary fallout from the lower exchange rate we experienced during the Asian crisis.

Movements in the exchange rate clearly affect inflation and, as such, are an integral part of any inflation targeting regime. That is why they are frequently mentioned by central banks, which operate monetary policy in this way. But there is no mechanical relationship between the level of the most frequently quoted measure of the exchange rate—the rate against the US dollar—and the future domestic price level. For a start, the price effects are better approximated by the trade weighted index or by other specially constructed indices. Secondly, a temporary movement in the exchange rate may have little or no effect on prices. So some attempt must be made at estimating medium-term developments, or at least market participants' expectations of medium-term developments. Finally, a change in the exchange rate may have different implications if it primarily represents international views about our economy and our policies, or if it is because we are being swept along with other countries in an international adjustment process.

All these factors are relevant and have to be taken into account with due weight. But that is done under the unifying framework of the inflation targeting approach to policy. As I have noted above, this approach has delivered tangible benefits and I am convinced that it will continue to do so.

Mr Chairman, it is a difficult time to be making monetary policy, as people constantly remind me. The world environment is changing. Most of these changes are for the better—our region is in recovery, as opposed to the severe recession of two years ago, and global growth is strong. Our terms of trade are improving. Some other changes, in world capital markets for example, are rather less benign for Australia. Adapting to these changing circumstances presents a challenge. At such times, it is important to keep our eye on the main goals—to sustain a long expansion and to address early potential imbalances which could impede that expansion's continuation.

However, we cannot assume that we have a choice of outcomes for the Australian economy in terms of growth and inflation which is invariant to what happens in the rest of the world. While we are benefiting from the stronger world growth compared with recent years, we will also be affected by the contractionary effects of the lift in world interest rates. As the forecasts I mentioned at the beginning show, the year ahead will most likely be one of slightly reduced growth and somewhat higher inflation compared to the exceptional outcomes of recent years. But, if we can sustain the economic expansion through a 10th and 11th year—even if its pace moderates for a time—and at the same time keep inflation low, we will have achieved something which has eluded us for three decades. That is a very worthy goal, and that is what we aim to do.

Before I sign off, I should mention two documents which I think every member of the committee has got. The first one is our *Semi-annual statement on monetary policy*, which is always produced before this committee meets so it can be used as a source of reference. The second one, which we have produced as a result of requests over recent periods, is a note on bank fees in Australia. This was produced for the committee.

CHAIR—Thank you very much, Mr Macfarlane, for a very comprehensive introduction. I think you have set yourself a very high standard, and you are obviously determined to keep it. Before we proceed to questions, I will need a resolution that that second document, submission No. 2 from the Reserve Bank, be accepted as evidence and authorised for publication as part of the committee's inquiry. Moved by Mr Somlyay and seconded Mr Latham.

Mr Macfarlane, in your opening remarks, you said that the last four rises in interest rates have given us more confidence that inflation should be contained. You went on to talk about there now being signs of slowing domestic demand, some of which may be in response to the tightenings that have already occurred. I wonder whether you might like to elaborate on that and, in particular, quantify some of the effects that you see as having occurred with those interest rate rises.

Mr Macfarlane—It is not an easy task, but I think that the most obvious sign we have seen to date has probably been on consumer sentiment and I suspect also on spending—although you are getting me straight into a difficult area here because I do not literally believe the retail trade figures. I do believe that spending was extremely strong last year, and I do believe it has slowed. But I do not literally believe, as the retail trade figures say, that in the March quarter we had the biggest decline in real terms in spending ever—deeper than we have ever had in the depth of a recession. I do not believe that. I have some other evidence I can quote if you want to follow that up.

CHAIR—Could you just follow up that point on the retail trade figures, before you go on?

Mr Macfarlane—Yes. I do not like starting a hearing by immediately attacking something, but I am not really attacking it. First of all, I am not denying that there has been a slowdown in retail spending. It had to slow down. It was going at a very rapid pace last year and it had to slow down. The other thing is that I do not want to be in any way thought to be criticising the Australian Bureau of Statistics. I think we have an excellent statistical bureau, struggling with the very difficult task of trying to measure things in a rapidly changing economy. But, as I said, I do have reservations about the retail trade figures. I was surprised that they were accepted reasonably uncritically because, literally, what they said was that in the March quarter this year we had the biggest contraction ever, and in the March quarter last year the biggest growth ever, in retail trade. That last bit, the contraction, I think overstates the situation. It also says that, over the whole year to the March month, retail trade has risen by only one per cent in value terms. If you ask the retailers, they have all got much stronger figures than that. The ones that I have here are Coles Myer reporting 5.6 per cent; Woolworths, 6.5; David Jones, 10.8; and Harvey Norman, 18.8. Of course, imports and consumer goods have continued to grow quite strongly. So I think we have seen a slowdown in retail trade but nothing like what is shown in the figures.

The difficulty for the statistician I think—this is a problem in every country—is that, as consumer patterns change, it is very difficult to keep up with them. For example, in my understanding, these retail trade figures do not have mobile phone fees, Internet fees or Olympic Games tickets—they will come in the September quarter. There are a whole lot of changing things that it is very difficult to keep up with. So I think there has been a bit of an overstatement there but, on the other hand, I do not doubt that consumer sentiment is more subdued than it was last year and that spending has come down.

One of the other areas where you would expect the rise in interest rates to have had an effect is in borrowing. But we do not seem to be seeing any of that at the moment. Borrowing is still going ahead at about the same rate it was last year. You would not expect to see anything on investment because the lags are very, very long there. Besides, we have already had a pause in investment, and most of the forward looking indicators suggest that that pause is coming to an end and investment may be picking up again.

CHAIR—Could you clarify that last point? When you talk about borrowing and investment, are you talking about household borrowing or borrowing for other purposes?

Mr Macfarlane—For both. Household and business borrowing has not really changed; it is still going at a fair clip. The average of the two is about 11 per cent. Household borrowing is growing faster than business, but that may well change in the near future. The main effect has been on household spending, and that is the biggest component of GDP. So, even though this may be only one item we can point to, it is a big one.

CHAIR—You have spoken about the inflation target of two per cent to three per cent in the medium- to long-term run or over the cycle or, as you said, ‘whatever words people want to use’. You went on to say that we accept that at times it will be outside this range but, if we think it is going to happen more than briefly, it calls for adjustments in monetary policy. I wonder whether you could expand on what you mean by ‘briefly’.

Mr Macfarlane—I think it is probably worthwhile spelling some of that out. The inflation target has been in operation since 1993 and it is a very good regime. First of all, we used to use as our reference rate the Treasury underlying measure of inflation. We did that because, at that time, the CPI had what we regarded as a distortion in it: it had interest rates in it. The statistician changed it so that it no longer had that distortion, and we now use the CPI as the thing we measure ourselves against in the long run. So that is the only change that has occurred in the inflation targeting regime. We now have a better reference rate. We have one that is much more recognisable. We have the one that is written into the contracts and that is in the headlines. The CPI is the one we use. That is the only change.

The other issue is: what is our attitude to overshoots and undershoots? That has never changed. Our attitude is that, in judging monetary policy, we aim to have inflation in the band in the period 18 months to two years ahead. In fact, we would like to have it in the middle of the band. But we know that, firstly, we cannot forecast perfectly; and, secondly, that shocks come along that we have not thought of. We know that there are all sorts of errors that can occur. So, over time, if these errors and these unforeseen events occur relatively randomly—some in an upward direction, some in a downward direction—we will sometimes find ourselves above the top of the band and sometimes find ourselves below the bottom. We would not regard that in itself as a big deal, unless we thought it was going to stay there for a long time and we were going to have a potentially inflationary situation where inflationary expectations ratcheted up, or a potentially deflationary situation. But, if we are above it or below it for a relatively short period, it does not particularly worry us.

The important issue too, which I want to get to straightaway, is: if we happen to have been above it, we do not say, ‘Oh, that’s a bad thing. We now have to offset that by squeezing down the economy and forcing the economy to be below the bottom of the band.’ Similarly, if we happen to have been below it, as we were for a couple of years until recently, we do not say, ‘Now we’re not going to target the middle of the band; we’re going to try to have inflation above the top of the band.’ We do not do that. I think I have explained this before: bygones are bygones; you are always aiming for the centre of the band; the worst archer still aims for the bull’s eye.

CHAIR—Can I take it from that—and I do not know whether including the GST or otherwise affects in 18 months time—your best estimate of inflation is somewhere between two and three per cent?

Mr Macfarlane—Yes, that is what I said in the opening statement. At the moment that is our best estimate. I think I said between two and three, and I stuck my head out a little bit and said that I thought it might more likely be in the top half of that than the bottom half.

Mr PYNE—Mr Macfarlane, in your opening statement you referred to the fact that, until relatively recently, we were receiving information on the growing economy and, therefore, there was a more recent slowdown. When did you first perceive that the economy was slowing down?

Mr Macfarlane—I think what I was trying to allude to there was that we had an exceptionally strong December quarter last year. The December quarter last year was exceptionally strong. That data comes in in the March quarter. Basically, it dribbles in. I suppose the last piece of data you got was the GDP figure, but you get all the retail trade figures and the employment figures. They come in in January, February and March. So, essentially, for a fair bit of the March quarter, in my view, we were still getting quite strong data. We were also getting two or three weak pieces of data during that time. We might get onto this later when we talk about the exchange rate. People were putting too much weight on those weak pieces of data but, in our view, we were predominantly getting good data. You cannot draw a line; you cannot say when you changed from getting predominantly strong data to slightly weaker data. But it was some time around the end of the first quarter, I suppose, if you had to hazard a guess.

Mr PYNE—So, relatively early in the year, you perceived that the economy was starting to slow down; yet, after that time, you increased official interest rates?

Mr Macfarlane—Yes.

Mr PYNE—Did you perceive that as being necessary to slow the economy down even further? Did you not look further to the end of the year and at what has occurred in other countries?

Mr Macfarlane—We do not judge monetary policy in order to achieve a particular output or GDP growth. We do not say that we put interest rates up because we want the economy to slow or that we put interest rates down because we want the economy to speed up. We know that that will be one of the many effects that will occur when interest rates are changed. But interest rates are adjusted in this medium-term inflation targeting framework. They are not adjusted to achieve a particular output for GDP growth.

Mr PYNE—With the recent data that indicates the economy is slowing down, how much weight are you putting on the decisions in the United States for the increase of interest rates in more recent times?

Mr Macfarlane—I think there are two questions there. The first one is the fact that we are getting more confirmation that the economy is slowing down. Other things being equal, that means it reduces the domestic threat to inflation and that has an impact on what we do with interest rates. So I think that was the first question. The second one was a much bigger one, and maybe we will come back to that at some later stage.

Mr LATHAM—In your opening statement, you pointed out that the CPI is moving back to near the top of the band, to three per cent. You then go on to say that it is ‘partly due to some temporary factors’. What are those temporary factors?

Mr Macfarlane—I think the main one is that oil prices—not that we think they are going to fall—which have been rising quite strongly over the last year, could well flatten out. So you will be taking out a big positive and replacing it with a zero. So that is a temporary factor. That is probably the main one. It is hard to see any others. There are some people who think that some anticipation of GST has led to a little bit of overheating in a few markets, so there might be some element of that. But I think the main one is really oil.

Mr LATHAM—On that subject, in your talk to the Economic Society of Australia on 11 February, you said that ‘We at the Reserve Bank are still operating on the assumption that the GST will affect prices only on a one-for-one basis, and that wages will not be raised to compensate for the GST.’ Are you still operating on that assumption, especially given the repeated observations in the semi-annual statement that second-round wage negotiations and inflationary impacts are already under way?

Mr Macfarlane—The answer is that, yes, we are still working on that assumption and that wage earners will not expect double compensation. In other words, we are working on the assumption that the income tax changes more than compensate for the GST and that wage earners will not expect another compensation through the wage bargaining process. I know that there are some contracts that have got little clauses in that say that, if this happens or that happens, they might be able to be renegotiated. But we do not think that is widespread and, at the moment, we are prepared to assume that that will be a negligible influence.

Mr LATHAM—Let me take you to page 2 of the semi-annual statement where you state:

> ... there is some risk that wage pressures will strengthen, particularly given recent increases in inflation expectations and the prospect of some high CPI figures later in the year.

How high is that risk? How would you quantify that risk: medium, mild or large?

Mr Macfarlane—I think we were referring there to things that were already happening. We were not talking about future wage bargaining after the introduction of the GST. We were talking there I think particularly about some of the industrial relations pressures that were occurring in Victoria in various sectors. We were really alluding to the fact that the balance of power has changed a little as a result of this long period of growth. The labour market is a bit tighter, particularly in some specific areas where it is quite tight. We were starting to see some of the unions, particularly in manufacturing and construction in Victoria, being a little more aggressive and demanding than had been the case in previous years. The increase in the CPI we were referring to was the increase between December and the March quarter from 1.8 per cent to 2.8 per cent. So they would not be looking at CPIs below the band; they would be looking at CPIs in the top part of the band.

Mr LATHAM—How do you quantify this risk of second-round wage pressures: mild, medium or large?

Mr Macfarlane—At the moment we are working on the assumption that it is mild.

Mr LATHAM—Since the release of the semi-annual statement—in fact, just last Wednesday—the ACTU has announced an industrial campaign to seek wages compensation for the impact of the GST. To what extent does the bank expect this campaign to add to the second-round wage effects already under way?

Mr Macfarlane—If it were successful, it would certainly add to those; it would push up domestic inflation and require a monetary policy response. But we are assuming that it would not be, that workers will have already been more than compensated, once through tax reductions, and that they will not be expecting a second compensation through the wage bargaining process.

Mr LATHAM—Just one final point: I found it quite unusual in your semi-annual statement that you talk about a material risk of second-round wage increases, yet on the final page of the document you assume them away. Is this an unorthodox practice: to identify risks in a document and then, in making your inflation forecast, to assume them away?

Mr Macfarlane—No, I do not think that is a correct interpretation at all. As I said, the bit at the beginning where we were talking about wage pressures was a description of what was already happening. The change in the balance of power through a long period of very strong employment growth and some tighter labour markets was referring specifically to Victoria, with the manufacturing sector and construction sector outcomes. The bit we were referring to in the forecasts—the bit at the end where we are looking ahead—still works on the assumption that there will not be second-round wage effects as a result of the GST.

Mr LATHAM—Honestly, you cannot be serious in saying that. Has there ever been a wages expansion in Australia that stopped dead at the present? Surely what is happening now in the labour market and with wages pressure has an impact for the future. It just looks absurd to identify that risk in the semi-annual statement and then, in the final sentence or two, say, 'Well, we factor that risk out; we assume it will not happen, and here is our inflation forecast.'

Mr Macfarlane—We have not factored out the bit that has already happened. In our assessments of inflation, and our assessments of the need for monetary policy, we have as part of it a recognition that the domestic sources of inflation are a little stronger than they were before, because of developments in the labour market. But, on the other hand, we do not have at the moment any very hard evidence. When we look at the figures for wage increases, we still have a very subdued result. But we have not taken anything away. We are still assuming the continuation of that underlying situation.

CHAIR—Mr Macfarlane, just on those earlier comments to Mr Latham, maybe you can clarify this point again. I think at one stage you said that you worked on the assumption; but in your semi-annual statement you make the point, I think quite categorically, that second-round effects can be avoided, provided it is widely understood that part of the initial price impact of the package—that is, the GST and tax reform—is temporary and that the overall price impact will be smaller and more than fully compensated by income tax cuts and increases in government benefit payments. That is a very categorical statement. I wonder whether you would like to reinforce that today.

Mr Macfarlane—I do not think I can. I think you read it out. I do not think I could do anything other than repeat it, which I will not do. We have not changed our attitude on that. Our view as to the effects of the GST is the same—although, going back to what Mr Latham was saying, over the last six months, there has obviously been some tightening in the labour market which has led to a little upward pressure, although none of it has yet come through in any of the series for earnings.

Dr SOUTHCOTT—Mr Macfarlane, in your opening statement, you talked about the composition of growth and said that you expected a slowing in private domestic demand with an increase in net exports. Do you have forecasts on the different components of the domestic economy? Are you prepared to tell us what they are?

Mr Macfarlane—In very round terms, net exports were subtracting from GDP last year—and I cannot remember what the figure was—I think, more than one per cent. All they have to do is go to zero, and that is equivalent really to an addition to GDP. With the other one, the fiscal one, the figures in the budget suggest that they should be about three-quarters of a per cent of GDP. So it is really quite substantial compared with last year. Even with a very substantial slowing in private domestic demand, it does not necessarily feed through into much of a slowing in GDP because of these other two factors that have come along.

Dr SOUTHCOTT—What are your forecasts for consumption and investment over the next year?

Mr Stevens—Our forecast embodies the idea that in the year ahead consumption growth will not be as strong as it was in 1999, which was exceptionally strong. On investment, our feeling is that, if you take the three components there, it is clear that non-dwelling construction investment is falling—and that will keep falling, I think; most forecasters accept that.

Equipment investment, which is the biggest of the three, looks to us as though it may be finding bottom about now and that, in fact, the forward looking Capex data from the bureau suggests that that will increase over the year ahead. Also, the other component is mainly but not only computer software, which has been growing at 20 per cent plus for some years now—a very similar story to what they see in the US—and I think that will probably continue.

The net of all those is that we think investment over the next year to 18 months is going to grow more than it has in the past year or so. So the broad arithmetic of this outlook is, as Ian said, that net exports—if you went through the year to September last year—were minus 1½ per cent of GDP. That goes to a zero or a small plus. Then there is domestic expenditure growth, which was running at 5½ per cent to six per cent. The net of the six and the minus 1½ gives you the four, 4½ per cent growth we have had. That domestic spending growth in the forecast slows down to more like four per cent type numbers. So you get this kind of shift in the composition.

Dr SOUTHCOTT—What impact in the composition of growth has the depreciation in the exchange rate had?

Mr Macfarlane—To date, it probably has not had any impact, because it is relatively recent; it is really something that has only happened over the last five months. The strong rise in exports that we have had in the 12 months to March, which I think is about 19 per cent or something, largely reflects the stronger world economy and the fact that our export prices have been going up. Imports, of course, have also gone up pretty quickly over that time; they have gone up by 13 per cent or 14 per cent. So, to date, there is no particular thing that you can identify. But, other things being equal in the future, the lower exchange rate would have a beneficial effect on export growth and it would conceivably reduce imports.

Dr SOUTHCOTT—What impact has the change in interest rates had on your forecasts?

Mr Macfarlane—At the margin, the change in interest rates has reduced the forecast.

Dr SOUTHCOTT—Is that mainly in consumption and investment?

Mr Macfarlane—Mainly in consumption.

Mr ALBANESE—Governor, just following on from Mark Latham’s comments, don’t you think with regard to wages that the Treasurer’s comments following the budget—where he outlined essentially that the tax cuts were something that were independent of the introduction of the GST—have undermined the argument which you have put that somehow workers should resist making wage claims as a result of the GST?

Mr Macfarlane—I am not sure exactly what the Treasurer said. But there is an argument, which I assumed was involved in this, which says that you should not look at these tax cuts at face value; you should recognise that some of it is returning bracket creep from previous years and, therefore, you should not count it as a sort of windfall gain. I do not accept that argument because I think, apart from one year, which was 1976, Australia has never had income tax indexation. The practice in Australia basically is that bracket creep gets spent—and that has happened over the last two decades—and that, from time to time, governments have taken the discretionary decision to reduce income taxes. They are reductions in income taxes. Whether they be because of a wage-tax trade-off or in this case compensation for GST, I think they should be taken at face value.

Mr ALBANESE—Given that prices are already increasing, as you have indicated in the March quarter, and there are rising interest rates, does the bank have a view as to what a good time would be for real wage increases?

Mr Macfarlane—Real wage increases have been occurring. In a good economy like this, with strong growth and low inflation, real wages should be increasing year by year—and, by and large, they have been.

Mr PYNE—Isn't it a fact that wage increases in the last five years have been occurring at a much faster rate than in the previous 10 years? Isn't it also a fact that, whatever the reason for the income tax cuts, whether they be for bracket creep or whether they be compensation for the new tax system, the effect of them is to compensate wage earners for any one-off increase in prices, regardless of the reason?

Mr Macfarlane—I cannot confirm your arithmetic about the five years and the 10 years, but it does sound plausible. It seems to me that the best way to get real wage increases is to have long, strong expansions with low inflation, and that is what we have been having.

Mr PYNE—So your advice to wage earners seeking increases in wages, particularly the ACTU, would be perhaps to wait and see and to take account of the changes to the new tax system over the next six months before they pressure for wage increases?

Mr Macfarlane—I would be very disappointed if there were generalised wage pressure for what I would call double compensation. As I said, we are assuming that it is not going to happen or that it is going to happen on a negligible scale.

Ms BURKE—Given that enterprise bargaining now occurs in a cycle, and that unions go into a bargaining period on the basis that an agreement is up and they are making those agreements on a two- to three-year process, isn't it therefore reasonable to put into those agreements a clause stating that they will have consideration of the GST and inflationary impacts?

Mr Macfarlane—No, I do not think so. If the GST impact has been offset or more than offset by income tax cuts, I do not think you can.

Ms BURKE—Therefore, you are holding true to your semi-annual statement that the bank still holds to the view that the overall effect of the tax package is more than fully compensated by other changes to tax and benefits?

Mr Macfarlane—Yes.

Ms BURKE—So you are quite happy to sit here today and say to the workers of Australia that two to three years down the track they will not be suffering impacts from GST or inflation and that they should have said to their unions there should have been some sort of clause in their agreements—an ‘in case something happens’ type clause?

Mr Macfarlane—I suppose you could never object to someone having an ‘in case something might happen’ clause in their agreement. The question is: when would you trigger such a clause? My belief is that these clauses should not be triggered if it can be established, as I believe it will be, that the income tax cuts more than outweigh the cost of the GST.

CHAIR—I think we have probably covered that from about three angles, so hopefully that is a clear answer.

Dr SOUTHCOTT—Is it true that New Zealand and Canada, when they introduced their GST, did not experience any second-round price effects?

Mr Macfarlane—I think the answer is that, by and large, that is the case.

CHAIR—It is in the centrefold in your semi-annual statement.

Dr SOUTHCOTT—The Melbourne Institute has assessed the risk of second-round price effects as being of the order of 20 per cent—that there is a probability of 20 per cent that there might be some second-round price effects from the GST. Does that accord with the Reserve Bank’s view?

Mr Macfarlane—We have not actually put a probability on it, but I am pleased to see that they have a relatively low number.

Mr SOMLYAY—Mr Macfarlane, you have told this committee before that the Reserve Bank can have only one monetary policy. Have you seen any evidence that the slowdown or the response to monetary policy may be more severe in some areas than others, particularly in some parts of regional Australia?

Mr Macfarlane—No, I have not, and I probably would not expect it. I think one would probably expect that the areas that ultimately would get the biggest impact might be the areas where there was a little bit of speculative activity, where things were maybe a little bit inflated—it might have been the areas at the top end. Typically they are the areas that often get hit first by a change in monetary policy. I think a lot of the rural areas, to the extent that they are exposed to the export sector, would have benefited from both the strong world growth and—maybe it is too early yet—to some extent from the falling exchange rate.

Mr LATHAM—On page 31 of your semi-annual statement, you forecast a massive increase in exports. Won’t rural Australia be the great beneficiary of that export boom?

Mr Macfarlane—Yes, it should be.

Mr LATHAM—Just on a different subject, also from the semi-annual statement, at page 38 you attribute the decline in the value of the Australian dollar in late January to ‘some political comments about interest rates'. What were these comments, and how did they damage the currency?

CHAIR—That has been fairly well canvassed in the media.

Mr LATHAM—It has not been canvassed here, and I am asking the question.

Mr Macfarlane—I think what we are really witnessing is a media event. I am very glad you read that thing thoroughly because it is virtually a 50-page document, and you managed to find seven words which I thought were relatively innocuous words. But I was not to know that one of the newspapers would turn that into a front-page banner headline and I was somewhat surprised and taken aback when that happened.

On that general subject, we have always expected that the Prime Minister or the Treasurer or both have the right to comment on monetary policy. There is nothing at all improper about it. Indeed, it was specifically allowed for in the statement on the conduct of monetary policy. Of course, it happens in other countries that have independent central banks. The classic example was when the Bundesbank was at its prime and everyone used to point to the Bundesbank as being at the pinnacle of central bank independence. But that did not stop the German minister of finance and the German chancellor frequently giving their views on monetary policy. It was also quite common in the United States, although less so under the current administration. Recently we have seen in New Zealand, which prides itself on the independence of its central bank, that both the Prime Minister of New Zealand and the minister for finance have been making comments.

So there is nothing involved that is improper or that is not in keeping with democratic principles or the agreements between us and the government. In fact, I think one of the reasons for this attracting a lot of attention is that it can happen only when you have an independent central bank. It cannot happen if it is the government making the monetary policy or if the government is the joint maker of monetary policy; it cannot get up and criticise itself or present alternative views. It seems to me that it is just an inevitable result of having an independent central bank in a democratic society.

Mr LATHAM—With all due respect, Mr Macfarlane, that was not my question. I have read interpretations of this matter in the media. But I assume that you produce the semi-annual statement for the members of this committee to read every word, including the seven that have been identified. People in the markets and the media also read every single word in your statement. I am asking you directly: what were these comments, and how did they damage the currency?

Mr Macfarlane—What we were doing, if you read the sentence, was reporting a view that developed in the market. That is all we said, that we were reporting a view that developed in the market. We were not passing judgment, and we were not criticising anyone. Of course, a lot of things happened at that time and they were incorporated in that view. Those comments were there in a part of the report which was simply written for the record, and we were astonished when one newspaper decided to put it in a headline. By and large, the other newspapers completely ignored it; they did not think there was any news in it at all. I think one of the others might have mentioned it in the body of an article that was to do with something else. What you are talking about really is a media event, not an economic event.

Mr LATHAM—Let me put the question a different way: how can the comments of politicians damage the currency; and what advice would you give to those politicians in the future?

Mr Macfarlane—It is partly a period that we are going through, which is a new period, and people are not familiar with the sort of situation that will probably be common—and was common, as I said—in Germany or the United States. It is common in places where you have independent central banks that there will be occasions when members of government or ministers present alternatives views to what are thought to be the views of the central bank. I think that is going to be just a fact of life. It is just going to be part of the landscape. I think what we have gone through is a period where it was novel and it got more attention than it deserved.

Mr LATHAM—A final matter on that point: you mentioned the power of the media, and you are obviously sensitive to it. Are you concerned by reports consistently over the last week, a lot of them emanating from the Prime Minister's office, that the relationship between the government and the Reserve Bank is openly hostile, and even at war? How would you describe the relationship between the Reserve Bank and the government? Can you also give a guarantee to this committee that the bank is still acting independently in setting interest rates, and that there should not be an interpretation in coming months that, if rates do not rise, this has been a product of political pressure?

Mr Macfarlane—There are about three questions there too, Mark. The first one is this business about warfare and all the rest. The same newspaper that made so much about those seven words is the same one that is doing that.

Mr LATHAM—My quote was actually from the *Financial Review*, which is a different media house.

Mr Macfarlane—Which one was that?

Mr LATHAM—There are numerous quotes in every paper about open hostility and war. Let's not just pick on the *Australian*. Let us be realistic about the situation.

Mr Macfarlane—I do not see any evidence of that. I do see different opinions being expressed, but I think the relationships are very good. On the final point that you wanted assurance on, I can give you complete assurance that there has been no pressure on the Reserve Bank board from any part of the government to get us to do anything other than what we would normally wish to do.

CHAIR—There is another part to that question—the independence of the bank. I thought you might want to respond to that part too. I think Mr Latham was raising that question.

Mr Macfarlane—We will continue to do what we have done in the past, which is to make our judgments as best we see fit on the basis of the evidence in front of us—on the basis of our forecasts. It has worked pretty well since we have been doing it that way, and that is the way we will continue to do it.

Mr PYNE—Mr Macfarlane, I want to follow on from Mr Latham’s questioning. The Treasurer made some comments recently on the radio about how the markets simply had to accept that there was a genuine independence between the Reserve Bank and the government. Perhaps their reaction to some of these debates was indicative of the fact that they have not got used to the independence of the Reserve Bank after decades of its being tied directly to government policy. In a perverse way, don’t you think that perhaps this argument between media outlets about the independence of the Reserve Bank, and the government’s response, has actually helped the perception of the genuine independence of the Reserve Bank and would probably add in the future to the market’s confidence in the independence of the Reserve Bank?

Mr Macfarlane—I do not know how to judge that—that is up to the market and the public to judge—other than to repeat an observation that I made before: this sort of situation can only develop in a democratic society with an independent central bank. It does not develop in a democratic society with a central bank that is controlled by the government.

Mr PYNE—So in fact the argument is really a symptom of that independence that you are talking of. It would not have occurred before the independence of the Reserve Bank because everyone would have known that the government was directing Reserve Bank policy.

Mr Macfarlane—Yes.

Mr LATHAM—Mr Macfarlane, just to quote your own words from your Shann lecture in 1998, you said that monetary policy in this country was politicised in the late 1980s and 1990s. Are you now saying that the bank was not independent at that stage, when, by your own assessment, monetary policy was politicised? To quote your own words, and there are more than seven:

> There was clearly great distrust of monetary policy, the Government and the Reserve Bank—or, in modern parlance, a lack of credibility.

Why should any reasonable person in the markets, or indeed the media, not believe in this lack of credibility these days, given the current controversy?

Mr Macfarlane—There weren’t those controversies in those days. There was never a controversy between the government and the central bank in those days. What I was referring to was outside observers, many of whom were associated with the opposition of that time, who were criticising the central bank. That was almost diametrical to what is happening at the moment.

Mr LATHAM—So when the government criticises the Reserve Bank, that is okay. Is that what are you saying?

Mr Macfarlane—That is a sign of independence.

CHAIR—I do not want to get bogged down on this. I thought you were referring to someone talking about being in back pockets. If we can just move back to the earlier question about monetary policy, you talked about your best estimates of 12 to 18 months ahead and that we would be within the target range. Can we therefore be confident that at the moment you see no reason to be increasing interest rates?

Mr Macfarlane—I cannot answer that one from anyone, whether it be from a journalist, from a market participant or the chairman of a House committee. That one is a bit cheeky.

CHAIR—I will come back to another point that Mr Latham was talking about relating to growth in exports, particularly agricultural exports and other commodities. Given that the Australian currency is still very much influenced by commodity prices, would it therefore give you some confidence over the course of the calendar year that, if commodity prices increased, that would have a positive impact on the value of the Australian dollar?

Mr Macfarlane—Yes, other things being equal, that should be the case. Of course, commodity prices have actually increased—not dramatically but they have increased compared to their low points in 1999—and the Australian dollar has not gone up. So there are obviously a number of factors at work, and commodity prices is only one of them.

Dr SOUTHCOTT—The Australian dollar is often seen as a commodity currency. Canada was in the same position and now, apparently, it is seen less as a commodity currency. In your semi-annual statement on page 38 you talked about how in the Australian share market there was a view that some Australian companies were seen as ‘old economy’, and you discounted that as being an important factor. But the Treasurer in March did give a very important speech outlining Australia’s record on things like Internet hosting, uptake of new technology, mobile phones and ownership of personal computers. I note that Australia now has only 52 per cent of our exports in commodities. Do you think it is a matter of gradually changing perceptions of Australia moving away from this notion of the Australian dollar and the Australian economy being primary industry and commodity based?

Mr Macfarlane—Yes, it is happening, but it is happening pretty slowly. Canada has a similar export base to Australia, but the thing that has benefited Canada—I have to be polite in the way I say this—is that it is seen as being almost a region of the United States. So some of the great optimism that surrounds anything to do with the United States has rubbed off on Canada because something like 70 per cent or 80 per cent of its exports go to the United States.

Ms BURKE—I am sorry to harp on about generalists and all the rest of it, but in your opening statement, you said, ‘From our perspective the decision to raise interest rates was relatively straightforward.’ It does not seem that that has been the view of the Prime Minister and the Treasurer, and even members of your own board. There does seem to be some confusion about why rates have risen and about the influence and the decision making processes of the board. I would like to quote two large slabs, so bear with me. In November last year you told this committee it was near impossible to talk of monetary policies in terms of official rates being accommodative, neutral or contradictory, yet in your February statement, where you announced a 50 basis point rise in interest rate, you commented that monetary policy was neutral. Later that month you commented that monetary policy was in a neutral zone. In the April and May statements announcing the consecutive monthly rise in interest rates, not seen in a decade, you have remained silent on whether the stance of monetary policy remained neutral or was now contradictory. In your April statement you explicitly noted the depreciation in the Australian dollar as a reason for raising interest rates, yet in your May statement—following much concentration in the market on your April statement concerning the currency—you were watering down the concentration and noting, 'There is, of course, no certain or mechanical relationship between interest rates and the exchange rate.' Governor, given this litany of confusion, and various other statements that surround it, can you now comment on whether there is inconsistency in domestic monetary policy actions? Can you make any comments on these varying statements you have been making over the last couple of months and, I suppose, on other people's comments in the press?

Mr Macfarlane—Why have interest rates gone up four times in the last six or seven months? The No. 1 reason is that they were so low to start with. In the middle of 1999 we had very expansionary monetary policy. Interest rates were extremely low in either nominal or real terms. The two most important rates—the mortgage rate and the rate to small businesses—were the lowest they have ever been in the deregulated era. You may have been able to find lower rates back in the days when they were quantitatively rationed but not in the deregulated era. They were extremely low, and of course the economy was growing very rapidly—six per cent growth in domestic demand. Credit was growing extremely rapidly. By any measure, we had an extremely expansionary monetary policy, so at some point, when we got over the reasons for that expansionary monetary policy—in other words, when we stopped having the contractionary effects of the Asian crisis—we were going to want to move interest rates up. When we did that, some people were taken aback. They were very comfortable with the way things were going in 1999. Everything seemed great. Why would someone come along and ruin the party by putting interest rates up? But we did. When I was asked about allocating the reasons for that between domestic and international things, I mainly concentrated on the domestic. Now interest rates have gone up four times. On the last two occasions they went up, there was also some mention of external factors and a specific mention of the exchange rate.

The first thing I want to say about that is that a lot of people at that time were taken aback—particularly after the April one—and I think you were alluding to this in your question that we should not mention the exchange rate. I do not know why they were taken aback, because the exchange rate has always been an integral part of any inflation targeting regime. There is nothing you can do to ignore the fact that depreciations of an exchange rate, on average, will cause inflation to go up and appreciations of an exchange rate, on average, will cause inflation to go down. If you are targeting inflation, this will obviously have an impact. The irony is that the inflation targeting regime has often been criticised in the academic literature because it pays too much attention to the exchange rate. And here I was being told by some people, 'You should not worry about the exchange rate; it has nothing to do with inflation targeting.' I just do not think they understood an inflation targeting regime.

The second line of observation was that a number of people were using what I would call the Basil Fawlty approach to monetary policy. Basil Fawlty said, 'Don't mention the war.' There was a very large element of that. People were saying, 'It may be important, but don't mention it.' It would be very difficult to be a transparent central bank and put out statements that did not mention what was an integral part of your thinking, and so we did. It is interesting that we did so again in May. In fact, in a much smaller press release, we mentioned the exchange rate five times. No-one complained; in fact, everyone said it was a very good press release. All the complaints were about the first occasion, and I think that was because there was some novelty value in it.

I think I have answered your question. The predominant reason for the tightening of monetary policy was because we started off at an inappropriately expansionary level, and we had to change with the circumstances. As we went through that period, international factors started to play a role, as did domestic factors. I am comfortable to talk about that if you want any more explanation on that area.

CHAIR—Just on that point, in some of your past statements you have referred to an expansionary monetary policy, or one that is less stimulative, neutral or tight. Recently you seem to have dropped those descriptions. I wonder what the reason for that is, and where we are now.

Mr Macfarlane—The problem with them is that they do run the risk of becoming a tautology—wherever you are is the appropriate level, wherever you are is neutral. If a whole lot of other factors change, you say, 'We have to have change it to bring it back to neutral.' It is a difficult terminology. Maybe the best way of thinking of it is in terms of averages. I think that is the sort of thing we had in our mind. By any objective criteria, by any historical comparison, we started with a point where interest rates were extremely low compared with average, and we did not think it was a good thing to continue doing that. A number of other countries reached the same conclusion at about the same time.

CHAIR—So where are we now?

Mr Macfarlane—Almost by definition, they have to be where they are. It has to be appropriate for the current circumstances and prospective developments; otherwise, they would be somewhere different.

Mr ALBANESE—What are the implications of the significant loosening in fiscal policy that we have seen in the budget and in the compensation package that you regard to be so terrific?

Mr Macfarlane—Before I answer that—and I have no trouble answering it—are we finished with the exchange rate? There are a couple of things I would like to say about the exchange rate.

CHAIR—We have not really got onto it yet; we have been dealing with monetary policy.

Mr Macfarlane—The exchange rate is part of monetary policy.

CHAIR—I am sorry, I mean with monetary policy being the primary focus.

Mr ALBANESE—I have asked a question, but I do not think the Governor—

Mr Macfarlane—I probably want to finish a few more thoughts on the previous question, and then I will get on to yours. I am not trying to dodge it. There is another thing too that is worth noticing, and which is I think very important. When the Australian dollar first started to fall, we fell against everyone. It has been only a five-month period where the Australian dollar has been falling. With the first period—if you use the first half of January as your base, and you look at what happened between then and, say, March or early April—we fell more than anyone did. During that period you could not simply say, 'Oh, it's just a US phenomenon. It is the US dollar going up, and therefore everyone else has to go down against the US dollar,' because we fell more than others did. For example, to the end of April we fell by 10 per cent, Canada fell by two, the pound fell by three and the New Zealand dollar fell by six. The only one that was near us—and it did most of it in April—was the Euro. At a time when some of those things were being written—and I have alluded to this in my opening statement—the falling exchange rate seemed to be making some sort of judgment on Australia.

Of course, we have heard a lot about the exchange rate in the last month. There have been a lot of headlines, but actually it has been a pretty good month—over the last month we have hardly gone down at all, and a lot of those other countries which seemed to be doing okay have now experienced the same thing that we have. So, over the last month we have gone down about two per cent, the pound has gone down six per cent, the New Zealand dollar has gone down six per cent and the Euro has gone down two per cent. If you look at where all these currencies are now, and you compare them back to the early part of January, it is now starting to look as though everyone is going down against a strong US dollar. That is probably a logical way for the international adjustment process to sort itself out. That was not the case halfway through the process. Halfway through the process, the Australian dollar seemed to be the one that was being hit; now it is more a generalised process of the US dollar going up against everyone else. I think that is something that you have to be more comfortable with; in other words, we are in good company.

Mr ALBANESE—I still have not had this question answered yet. Even given the Governor's outline about the more recent downturn, the fact that you have indicated that depreciation has an inflationary impact to a more-or-less degree, added to the significant loosening in fiscal policy in terms of income tax cuts and compensation for the GST—and also what we might call political compensation for the GST in some of the budgetary programs—what is the combined impact of that on interest rates particularly, on pressure on interest rates?

Mr Macfarlane—Are we onto fiscal policy now? Have we finished with exchange rates and onto fiscal policy?

CHAIR—We have not finished, but we will take the question.

Mr Macfarlane—I often get this question; it is phrased in different ways. A common way of phrasing it is: why don't you spend more time criticising fiscal policy? Mark used to ask, 'Why don't you spend more time criticising fiscal policy? That is what central bank governors are supposed to do.' There is a twofold answer: the simple one is that the current stance of fiscal policy is not making the Reserve Bank's job any harder, so we have no desire for a different fiscal policy. Some people are surprised to hear that because, in the past, the Reserve Bank Governor spent a lot of time giving sermons on the need for tighter fiscal policy. The reason is that, for most of the last 20 or 30 years—or a lot of the last 20 or 30 years—there have been situations where we have really had to worry whether fiscal policy might have been on an unsustainable path. In fact, on a number of occasions that was the case—it appeared to be on an unsustainable path. But that is not the case now, of course. How would you know if it was unsustainable? Basically, it all depends on the financing of the deficit.

There was a time when the deficit used to end up being funded by the central bank because the government could not sell enough debt to the public. That stopped in 1982. Then there was a period where the budget was always responsibly financed but, if the budget deficit was large enough, it meant a huge amount of debt had to be sold and that put upward pressure on bond rates. Then we heard all about crowding out and all the rest. Neither of those funding things are an issue at the moment because next year will be the fourth year in a row where there has been a surplus. There is no borrowing. The government is not doing any borrowing. In fact, when I am abroad I often show as a great virtue of Australia that the outstanding stock of government debt to GDP is lower in Australia than in any developed country. So it is very hard to get excited or to feel that somehow there is something happening in fiscal policy that is making the Reserve Bank’s job more difficult.

That does not mean that I am denying there is any link between fiscal and monetary policy. I am not saying that it is only the financing link. There can be another link, but for the other link to work the fiscal policy actually has to affect the economy. And then, having affected the economy in a particular way, we might have to respond. For example, if we had an economy that was growing too fast and a big fiscal expansion came along, that would obviously cause it to grow even faster. It would have inflationary consequences and interest rates would have to do something—they would have to rise. Similarly, if an economy was slowing and we had a very big fiscal contraction, it could push it into recession and reduce inflation in the process. This would mean that interest rates would have to be reduced. Again, I want to say that the fiscal policy has implications for monetary policy only in so far as it causes the economy to do something undesirable and in so far as it destabilises the economy. At the moment, that is not happening. There is no doubt going to be a fiscal stimulus, but it is going to come along at a time where we think private demand is slowing. The net outcome of all these things is going to give us a growth rate which we think is pretty reasonable. We do not see any reason why that is causing us to do something with interest rates that we do not want to do.

Dr SOUTHCOTT—I want to ask you about the exchange rate as well. In 1998 we saw that a depreciation on import weighted index did not carry forward completely into price inflation due to competition in a world disinflationary environment. Does the bank have an estimate of what a sustained one per cent change in the import weighted index would mean for inflation?

Mr Macfarlane—There are two parts to that question. The first one is that 1998 was different from now because we had all this deflationary stuff going on around the world. It was also different because the fall was short lived. Glenn might as well answer your other question about what would happen in normal circumstances if it was long lived.

Mr Stevens—Historically the research on this has come up with the finding that 10 per cent off the exchange rate permanently amounts to about three per cent on the level of the CPI in the long run—that is the level of the CPI, not its growth rate. Of that three per cent, you get one per cent in year one. So the inflation rate in that year is one per cent higher. That is the historical research that we have done in the past, and that is the average finding over 20 years of exchange rates going up and down. I think the staff would probably be inclined to shave that a little bit these days, on the basis of some of the earlier experience that you mentioned, and call it maybe six-tenths or seven-tenths of one per cent in the first year on the inflation rate—all other things being equal which, of course, in real life they never are. I should emphasise again that those kinds of findings are the results of statistical research over a longish period. It is an average outcome; it is not necessarily exactly what you might get in any particular episode. Those are basically the results we have had.

Dr SOUTHCOTT—To what do you attribute that fall on the historic data and what you think it is now? Is it due to more competition?

Mr Stevens—I think it is due partly to that, and I suspect it is partly due to something else which is also related to the change in the competitive environment—that, for a lot of the history where you are trying to estimate what an exchange rate change does, we had high inflation. The whole mentality makes it such that it is easier to pass on these price rises in a high inflation world, and these days we are still in a low inflation world. The change in competitive conditions related to that as well, so those things combined mean that these impacts may not be quite as big as we might have feared in the mid-1980s.

Dr SOUTHCOTT—So, for example, a sustained seven per cent fall in the import weighted index could mean four per cent to five per cent inflation in year one?

Mr Stevens—Point four.

Dr SOUTHCOTT—Sorry, it is 0.6.

Mr Stevens—It is a lot less than one per cent. That, at least to some extent, is factored into these forecasts already—not all of it, but some of it.

Mr LATHAM—Just further on the exchange rate, on page 39 of the semi-annual statement the bank states that it has not intervened in foreign exchange markets. Is this still true today?

Mr Macfarlane—We never comment on whether we have intervened or not. The data is made available monthly, but we never comment.

Mr LATHAM—You commented in the semi-annual statement but not today.

Mr Macfarlane—We comment on what we have done, yes.

Mr LATHAM—Would you care to comment now about what you have done?

Mr Macfarlane—The figures are available on a monthly basis, and they show we have not done anything.

Mr LATHAM—In a speech to CEDA in November 1996 you said:

> Our new found credibility in international capital markets has other policy implications. The popularity of Australian dollar investments ... has lifted our exchange rate appreciably at a time of subdued commodity prices.

Is the reverse true today—that there is some problem with our credibility on the inflation front that is causing the exchange rate to be weak at a time of subdued commodity prices?

Mr Macfarlane—I think I have answered that in a way. There was a period where we had some worries that that might be happening, and that was that period when we seemed to be the only one that was copping it—where the Australian dollar was going down against the US dollar faster than others. But it turns out that that was not the case. It turns out now that the others—the New Zealanders and the Brits and the Euro—are all experiencing the same sort of thing. So I do not think that is an issue now, although it certainly was something we were looking at as we were going through.

Mr LATHAM—Finally, following your statement announcing a rate rise on 5 April, there was widespread speculation that the bank had entered a new policy making phase based on exchange rate targeting. The *Australian Financial Review*, for instance, reported that senior government ministers were alarmed by this switch, one describing it as ‘half a work in progress which could have some disturbing implications’. What reaction have you had from government ministers to this particular issue, arising from the statement on 5 April?

Mr Macfarlane—I do not think anyone believes that we were into it. I do not know what exchange rate targeting means. To me it means some sort of quasi-fixed exchange rate. The interesting thing is that, if you go back over the period of our floating exchange rate, we have been prepared to let our exchange rate vary a lot more than most other countries. We have been true to the spirit of a floating exchange rate, much more than a lot of other countries. We still are a country that is prepared to let our exchange rate vary, and we have had a lot of benefits in the past by letting the exchange rate vary. On the other hand it is not something that you can ignore; it still does have some implications in the long run if you run an inflation targeting regime.

Mr LATHAM—So you have had no reaction from government ministers on this issue, or from Mr Ted Evans, the representative on your board?

Mr Macfarlane—I have not heard anything from government ministers saying that we were exchange rate targeting.

Mr LATHAM—Or from Mr Ted Evans, their representative on your board?

Mr Macfarlane—I cannot remember every word I have ever heard from him, but I cannot remember him using that phrase.

CHAIR—Just to clarify that last point: since you do not have an exchange rate target and you talk about intervening only when things are disorderly, does this mean that, if inflation stays within our target, we therefore do not have to follow the US on interest rates?

Mr Macfarlane—If inflation stays within its targets, you do not have to do anything. If inflation stays within its target—and if the prospects for inflation are that they will stay within their target—there is no prima facie reason for changing monetary policy for any reason.

Proceedings suspended from 11.32 a.m. to 11.48 a.m.

CHAIR—We will now talk about a whole range of issues, but I would like to go over one area to flesh out a bit more on how you see things in relation to the United States economic situation. In particular, their inflationary pressures seem to be significantly more than ours. I wonder whether you might like to compare that a bit more with the Australian situation. Clearly, there is more pressure on the Fed in terms of interest rates than I assume, from what you have been saying so far, there is on the Australian situation and therefore the expectation as to how far, if any further, Australia has to follow any further rises that the Fed might announce.

Mr Macfarlane—You are talking about inflationary pressures in the US. I would agree with you that they are greater there, although in terms of actual inflation, it is remarkable how similar we are. We both have headline inflation rates—ours is 2.8, I think theirs might be three—and we have underlying inflation rates of about 2¼ in both places. So, in terms of the record, where we are at now we are remarkably similar, but in terms of looking ahead, I think I would have to agree that the US has more inflationary pressure in the sense that the economy is growing quickly. It speeded up in the March quarter, which we do not think happened here—we think we slowed down—and the wages costs have speeded up. The recorded figures have speeded up, whereas here our recorded figures on wages have been rock steady. So it is true that they have an orthodox approach to monetary policy. Even before we mention asset prices, they have a prima facie reason for what they are doing, which is raising interest rates.

In addition, they have this other complication which we have not got, and that is extremely inflated asset prices. We are not allowed to say that they are having a bubble, because no-one ever knows whether you are having one until it has broken. It is starting to look as though there is enough evidence to say that there was a bubble in the Nasdaq in the first quarter of this year, so they have inflationary pressures that say they should be tightening monetary policy. But they have inflated asset prices, so they have to be rather cautious about how they do it. To date they have been quite cautious, so I suppose I do agree with your central proposition that there are more inflationary pressures in the US than there are in Australia.

CHAIR—And by implication, therefore, their pressures to increase interest rates are significantly greater than ours.

Mr Macfarlane—Getting back to something I was saying before, they are probably greater than not just us, but other countries. As I said, over the last month, even though there have been a lot of headlines about what is happening to exchange rates in Australia, it has not been a bad month for us. We have not moved all that far. The big action has been big falls in other currencies, such as the pound sterling and in New Zealand. Canada is starting to edge down a little now, although Canada is seen to be very much like a region of the US. So we may be entering this world, which would not be an unreasonable world, where the US does one thing and everyone else does something different.

Mr PYNE—Talk of the US economy, inflation, interest rates, et cetera, leads us to the question of how much our exchange rate is linked to commodity prices versus other influences. It was always accepted wisdom until the last 12 months that commodity prices and the Australian dollar were inextricably linked, but there seems to be more evidence these days of economists saying that that is not the case. In that case, could you outline what you think the influences are in the weighting given to each one with respect to our exchange rates, and how much commodity prices have an impact on our exchange rate vis-a-vis other movements in the United States economy, et cetera?

Mr Macfarlane—I think the reason we are talking about the exchange rate is that, over the last five months, it went one way and commodity prices by and large went another way. So the link has not held over this period. The attention seems to have been more concentrated in the international capital markets. The attention seems to have been more related to what is happening to interest rates, and what is likely to happen to interest rates in the future. I think that has been a much bigger explanation of what has happened to the Australian dollar. Someone mentioned that, for a time, there was this talk about ‘new economy/old economy’. I do not know how important that was, but the fact that a lot of people mentioned it means that some people must have been influenced by it. I think it has become a less glamorous topic now that the Nasdaq has fallen quite sharply, and that around the world in most stock exchanges it is the technology sector doing badly rather than the technology sector doing so well.

I also agree very much with the proposition that, even though we do not have a big listed IT sector in our stock market, it does not mean that we are technologically unsophisticated. We are actually quite technologically sophisticated and we have, as a country, been very willing to embrace new technology as is indicated by any one of a number of indicators that you can look at, such as PC ownership. The ones I have used is e-commerce servers per head of population and Internet usage per head of population. These sorts of measures indicate that, right across the board, households and businesses in Australia have been very willing to embrace new technology. We are always up there in the top quartile, sometimes in No. 2 or No. 3 position, behind the US or some of the Scandinavians. I do not think that the old economy/new economy thing, whilst it did have an influence for a time, is having as much influence now.

Mr PYNE—With respect to the exchange rate, you said earlier that you were unconcerned about the fiscal policy of the current government because of the surpluses being delivered for the last four years. Recently there was an article in one of the newspapers—I cannot remember which one—about fiscal virtue not being its own reward. How much impact do you think that the fiscal virtue of the government has on the exchange rate and the weighting given to the performance of the government’s fiscal policy? Or don’t you think that is having an impact as much as it perhaps used to?

Mr Macfarlane—I think in a medium-term sense, fiscal policy is extremely important. If people think that you have an unsustainable fiscal policy—that you are not going to be able to fund it or that the funding of the deficits is going to cause huge strains on your capital markets—I think you do suffer, and your exchange rate will suffer. I think that, once you have moved into sustainable territory—in other words, once you are in the good book—as we are internationally, there is no doubt then that variations of half a per cent or one per cent in the size of a surplus do not have any identifiable effects on the exchange rate.

Mr PYNE—Earlier you also talked about periods in Australia's economic history of unsustainable fiscal policy, and you highlighted the early 1980s as one of those periods. Was another period the early 1990s?

Mr Macfarlane—If you go through the graphs, I think you will find periods in the 1970s, periods in the 1980s and periods in the 1990s. I think they are eminently bipartisan and in fact, both parties have been in office during periods where fiscal policy was a problem.

CHAIR—That is a very diplomatic answer.

Mr LATHAM—It is probably true.

CHAIR—The Treasury, in the budget statement, pointed out that they saw the economic growth potential at 3½ per cent to four per cent and little evidence to suggest that there would be a deterioration in the availability of labour over the forecast period. Also, I think it has been seen that, with the reforms that have been put in place in Australia in the last few years, we do seem to be able to sustain a higher rate of growth without the inflation break-out. Does this in your opinion mean that we can get through this transition period over the next 12 months relatively unscathed, in a way that we would not have been able to a few years ago?

Mr Macfarlane—I think we are in better shape than we were. I think it is true that some of the reforms have made goods markets more competitive and, to some extent, labour markets more competitive. Yes, it has put us in a better position, but I think a lot of it also is due to low inflation—the fact that we have had nearly a decade of low inflation. People accept that as being normal rather than being a fluky thing that is going to go away again. I think that is equally as important as the increases in flexibility in goods and labour markets.

Mr LATHAM—Just on that question of inflationary pressures and the general state of the economy, could I ask Mr Stevens a question about the NAIRU? In a speech in October last year, you said that there was little evidence to show that the NAIRU is lower than it used to be—that is, around seven per cent to 7½ per cent as measured by empirical studies. In the light of inflationary performance and the precious building in the economy this year, does that remain your assessment—that there is no evidence of a NAIRU below seven or 7½? NAIRU stands for non-accelerating inflation rate of unemployment.

Mr Stevens—I think what I said was that wages growth had remained subdued while unemployment came down from nine to eight to 7½. That was not evidence that the NAIRU had fallen below 7½. That is what is supposed to happen if the NAIRU, assuming that it exists, was at the old figure.

To the extent one can say much about this, my guess would be that economists will probably find, when they run their regressions and so on in the years to come, lower figures for NAIRUs than they used to do. Having said that, I should also say that, as Ian said a few times before, doctrinaire views about what NAIRUs might have not really featured much in the policy decisions—in fact, they have not featured at all—so I think it is probably important to keep that in mind when we are talking about analytical constructs like NAIRUs.

Mr LATHAM—It became an issue quite recently when Access Economics released information prior to the federal budget showing the structural deficit for 2000-2001 to be a worrying $5.6 billion. This was based on a NAIRU estimate of 6.7 per cent. On the day before the budget—8 May—the Treasurer, Mr Costello, tried to counter the Access material by saying that the NAIRU in fact was well below 6.7 per cent. I assume from this that the RBA is on the side of Access Economics: that the NAIRU is not that low, and in fact the structural budget deficit is at the very least $5.6 billion. Surely this is a huge concern—to be in the ninth year of economic expansion and have a structural deficit of that order.

Mr Macfarlane—We are getting into this very technical stuff here, Mark. As people will not be surprised to know, I am one of the least enthusiastic people about the concept of NAIRU. I have never shown any enthusiasm for it, and it certainly does not figure in monetary policy decisions as they are made in Australia. The other thing I would like to point out is that this business of getting a budget position and doing something to it is an old game. It used to be called full employment budget deficit or, sometimes, a cyclically adjusted budget. It often leads to very unusual results. That is why most treasuries do not rely on it.

I can remember in the mid-1970s when exactly the opposite was occurring. We had what we thought was a very big budget deficit, and it was a big problem in Australia. We had groups of academic economists saying, ‘Oh no, but if you cyclically adjust it, it’s really a surplus.’ It was true in the mid and late 1970s that the deficit was excused by a lot of people because they said that if you took account of the fact that the economy was growing less rapidly than it could, it was really a surplus. What we are seeing now is the obverse of that. People coming along and saying, ‘Your economy is growing much faster than its long-run potential; if you slowed it down then the surplus would disappear and become a deficit,’ so I am very sceptical of such calculations, having seen them being used in both directions.

Mr LATHAM—Just on the budget position, in your own words when we last met in November, you said:

> ... given we are in the ninth year of an expansion and we had big deficits in the early years, shouldn’t you be counterbalancing this with big surpluses in the latter years of an expansion? The answer is yes, in principle I think you should.

Isn’t there a problem that we are not counterbalancing this with big surpluses in the latter years? You have seen the surplus from the last budget—just $200 million once you strip out the asset sale of the spectrum. Isn’t this just bad economic policy by your own statement in November last year?

Mr Macfarlane—I think you have selectively quoted me there. I think those words ‘in principle’ are pretty big words.

Mr LATHAM—I read all your words.

Mr Macfarlane—Then I went on and said, ‘If I were a dictator may be I could do it, but I find it very difficult to see how you can do it in a democracy.’ The classic example there was New Zealand, which at one stage was putting out these forward estimates showing that they would have surpluses of eight per cent of GDP, and everyone around the world was applauding them and clapping them. Those eight per cent of GDP surpluses never occurred at all. In the event, they took the decision to reduce taxes and to make sure they did not have those surpluses on the grounds that essentially they did not have a funding problem anyhow, so they could not see—and the public would not be able to see—the point of paying all these taxes to the government which had nothing to do with the money. In fact, we could even conceivably have been in a position where we had massive surpluses, where not only would we have paid back all our debt but the government would actually have to start buying some assets. As I said then, in principle you can see a sort of arithmetic logic in saying that, if you have deficits at one stage, you should have equal sized surpluses at another stage. I think it is extremely difficult to achieve that in a democracy. People ask, ‘Why am I paying all these taxes to the government, when they do not even know what to do with them?’

Mr LATHAM—Do you acknowledge the possibility that statements like that—more the statement of a politician than a reserve banker—weakens your credibility in the eyes of the market? If you go to Budget Paper No. 1, even the Treasury clearly states that sound fiscal policy can limit the risk premium attached to interest rates. Isn’t it better for the stability of our currency and for inflationary targeting in this country for the head of the Reserve Bank to be matching statements like that and clearly stating that it is better in this country to have sound fiscal policy and that we should have a stronger financial position on the federal budget in the ninth year of an economic expansion?

Mr Macfarlane—I think internationally we are regarded as having a very good fiscal policy. We are probably regarded as having a fiscal policy which is almost second to none. I know a purist would say, ‘You have to draw this line and you have the deficits below it, and you have to make sure the surpluses above it are an equal size,’ but I do not think anyone by and large has been able to achieve that.

Dr SOUTHCOTT—What impact does having a low government debt have on market interest rates?

Mr Macfarlane—In principle, it means that the bond rate is lower. If there is a declining supply of government bonds, and there are a lot of people who want to buy Australian government bonds, they compete for them and drive up the price. That drives down the bond yield. I do not know what the figure is today, but basically our bond yields are about the same as the US, which is unusual. One would have thought that we should have slightly higher bond yields than the US because the US market is so huge, liquidity is so great and all the rest, but at the moment our bond yields—as I say, I have not checked up today’s figures—late last week were virtually identical to the US.

Dr SOUTHCOTT—Relating to Mr Latham’s question, as I understand it, in the last five years from 1991 to 1996, there was $80 billion accrued in government debt and, in the subsequent five years, $50 billion of that has been reduced. That must have an impact on the government’s fiscal position and presumably, in principle, on market interest rates.

Mr Macfarlane—Yes, it does. But we had better be careful that we do not tell you that it is all due to governments running surpluses. A lot of that was due to privatisations. That reduction, the second phase, was due to privatisations.

Dr SOUTHCOTT—Can I ask you a question about the way the board operates? When the board makes decisions, does it do it by consensus or by votes?

Mr Macfarlane—Essentially by consensus, although you cannot guarantee consensus.

Dr SOUTHCOTT—Are you able to say whether recent decisions have been unanimous?

Mr Macfarlane—No, I am not able to comment on that.

Mr ALBANESE—Just on the inflationary expectations, you seem to make an assumption with regard to continued wage restraint that is based upon income tax cuts being more than fully compensating for the GST. I wonder what the basis was for that assumption—whether you have actually done any independent modelling of the impact or whether you were relying upon Treasury analysis.

Mr Macfarlane—We are relying on the Treasury analysis. I certainly have not done any independent analysis. I think they know a lot more about that subject than we do.

Mr ALBANESE—So the bank has done no—

Mr Stevens—The period we are coming into is not an event you can model—it has not happened before.

Ms BURKE—Given the impact upon inflation and the bank's predominant role in inflation, why haven't you undertaken or tried to do some modelling to see where it is going and what impact it will therefore have upon inflation?

Mr Macfarlane—We do. We do not do modelling. We certainly have given it a lot of thought and we are very aware of the time profile of what inflation looks like being. We have given it a lot of thought, and I have given you the results of that thought.

Mr ALBANESE—Particularly in the context of the fact that the government's assessment of 1.9 per cent as the inflationary impact of the GST would appear to be talked up by the government itself.

Mr Macfarlane—That is not the current assessment; I think the current assessment is 2¾.

Mr Stevens—That is in the first year. That is not the long-run figure, which corresponds to the 1.9 you mentioned. It is actually lower than 1.9 now—1¾ I think—so it is important to keep clear the time profiles that these numbers refer to. The 2¾ is the net effect in the year to June 2001.

Ms BURKE—Only last year the Assistant Governor, Glenn Stevens, noted that the economy was operating close to potential outcome. Is that the view held by the bank now?

Mr Stevens—I think I said we were operating closer to potential than we had been. I think the basis for that is the measures of capacity utilisation and things like the unemployment rate were, and have been, declining. What that tells you in a very simple way is that, wherever capacity is—and nobody knows exactly where that is—it had gotten closer than it had been a couple of years before. That was the basis for that comment.

Ms BURKE—Therefore, do you think that the government's budget forecasts of a slowing growth from 4.25 per cent in 1999-2000 to 3.75 per cent in 2000-2001 is consistent with your views of the economy and the current economic data? I will open that up to everybody, obviously.

Mr Stevens—As Ian said at the beginning, we do not have any particular quibble with the 3¾ . I think that is a pretty realistic figure.

Mr LATHAM—I want to go back to the question of the relationship between the Australian and the United States economies. I think there is a very important statement on the first page of the semi-annual statement. With respect, you say in relation to inflationary prospects in Australia that much will depend on the success of US monetary policy in reining back the economy in a timely manner. How confident are you that this will happen?

Mr Macfarlane—I think we are all agreed that that statement is a reasonably sensible statement—it is not a very specific one. But I think around the world it is not just Australia but a number of other countries are hoping that the US gets done what it has to do reasonably quickly rather than for it to happen very slowly. We have had experiences in countries, including this one, where there has been such optimism, particularly about asset prices fed by big increases in wealth—where people have shrugged off interest rate increases until they have had to be much bigger. We had something like that in the late 1980s, and we are certainly hoping that that is not going to be the case in the US. It would be a much more comfortable situation for everyone if the increases that occur in the US were to have a reasonably quick impact in getting the economy to slow. Probably a by-product of that would be some fall in US asset prices, but I think the situation we have had to date in the US is that the Fed has been reluctant to tighten interest rates simply to bring down asset prices. They have had to wait. They did not feel they had the mandate to do that. They have had to wait until they have seen old fashioned measures of inflation, like wages picking up, before they could act. Now they have those measures and they are starting to act more decisively than they were before. They moved some 50 basis points last time; in the past they were moving in 25s and there were often big gaps between them. So we think that there is a good chance that the Fed will be successful in the not too distant future in getting the US economy to slow down—getting prices and wages to slow down—without having sort of cataclysmic effects on the US asset markets.

Dr SOUTHCOTT—They did try in 1996, didn't they, to address asset price inflation?

Mr Macfarlane—I think that is when Chairman Greenspan made his famous statement about irrational exuberance. Looking at the US from the outside, you get the impression that, because the Fed is held in such high esteem throughout the rest of the world—and I hold it in high esteem—everyone thinks it is just great and that Chairman Greenspan can do what he likes. But if you go into the US, you will find that there are a huge number of critics and that he cops lots of flak. He is constantly being told he should not raise interest rates, and what a terrible thing he has done. So he is under the same sort of pressures domestically as every central bank governor.

CHAIR—I trust you are not provoking us there, Mr Macfarlane. Coming back to some comments that Mr Stevens made earlier about the effects of depreciation of the exchange rate, and so on, and the effect on the CPI, since you quantified it in the way you did, wouldn't that be a first-round effect in terms of inflation? Therefore, wouldn't you to have take regard of that when you are setting monetary policy?

Mr Macfarlane—Do you mean in the USA?

CHAIR—No, locally.

Mr Macfarlane—I think we have said that. We have said that movements in the exchange rate are part of the things you looked at in an orthodox inflation targeting regime.

CHAIR—You were talking you about it as a long-term effect, but isn't it really a first-round effect?

Mr Macfarlane—I think what we were saying was that if it went down and stayed down and nothing else happened. The other thing I should mention, if I can come back to this again, is that it is not really the Australian dollar-US dollar that you feed into these calculations. It is either the trade weighted index or various other things such as import weighted indices. This is another thing where it is what is happening in the whole world that matters rather than just what is happening between us and the US. We were in a situation where it was the Australian dollar that was going down, and other currencies were not, and that meant that our trade weighted index was going down quite quickly. If you were in a world which I think we are now moving into, and we have been in for the last month, where it tends to be non-US currencies as a whole going down relative to the US, then mechanically that is better for us because our trade weighted index is not going down as fast if we are in that world than when we were in a world where it is simply us going down against everyone. So the inflationary implications are different in the two circumstances.

Mr SOMLYAY—With the US dollar appreciating against the rest of the world, won't that act as an a contractionary force on the US economy?

Mr Macfarlane—Yes, it will. It is both contractionary and anti-inflationary. They have been getting the anti-inflationary effect for some time, and they are also starting to get the contractionary. You can see the contractionary effect through their trade account. For example, on Friday a figure for the US trade account was published which was an all-time record, and that is one of the things that got a few people in the US worried. So we saw the US dollar go down a little and the stock market went down a little because that mechanism was starting to work. That is another thing. When the chairman asked how long it was going to take US monetary policy to work, the exchange rate channel is one of the channels through which the tightening of US monetary policy is working.

CHAIR—I think the committee has finished on monetary policy.

Mr LATHAM—No, I have a few more matters.

CHAIR—We do have a couple of other things, but go on.

Mr LATHAM—What is the problem? We have got until 2 o'clock, haven't we?

CHAIR—If the governor is happy to stay until 2 o'clock.

Mr LATHAM—We are scheduled until 2 o'clock. This is undoubtedly the most important hearing we have had in a long while, and I think the Australian public wants scrutiny of an important policy area.

CHAIR—So let us proceed and finish on the monetary policy.

Mr LATHAM—On the question of the exchange rate, you made a statement earlier on, which is reinforced in the semi-annual statement—that there has been no currency market intervention. But hasn't the bank also been running down reserves? Isn't the impact of not selling Australian dollars the same as buying them—that this is a form of intervention and that intervention, coupled with interest rate rises and perhaps more direct intervention last week, means there is a lot of effort going on by the bank to underpin the value of the dollar?

Mr Macfarlane—You are referring to the fact that when the government needs foreign currencies that we normally provide it from our reserves, that we normally choose when we then want to go and replenish our reserves in the market and that we have been choosing not to go and replenish them in the market. That is right. It has been happening. I would not actually call that intervention, but we are quibbling over semantics—some people could. Obviously what we have been doing there is entirely open; it is published every month. In some sense it is just passive. We are not doing anything particularly active; we are just not replenishing. So at the margin that does have an effect, I agree.

Mr LATHAM—Just back on that question of a relationship between the Australian and the American economies—this has been in the news recently—I noticed in the semi-annual statement that you talk about a strong link between long-term market interest rates in Australia and those in the United States, possibly reflecting the link between the business cycles in the two countries and the broadly similar performance on inflation. Yet last week the Prime Minister and the head of the department of Treasury were saying something quite different. Are you worried that these conflicting messages about the stance of monetary policy are causing confusion in the markets?

Mr Macfarlane—I do not think there is any conflict there because what you were quoting was about bond yields. We are essentially talking about 10-year bond yields, which are not a direct reflection of what is happening to monetary policy. If you wanted to use an interest rate to characterise monetary policy, you would use the overnight interest rate—you would go to the shortest end of the spectrum rather than the long end. Whilst we are on this subject, I want to make a point that a lot of people think there is some great virtue in having very different interest rates to the US in bond yields. We are not talking about monetary policy; we are talking about bond yields. Some people have made the mistake of looking at how close our bond yields are to those of the US and have said, 'That's terrible, we've lost our monetary independence,' but I can take you back to plenty of times where we had different bond yields to the US, and it was always in the one direction—ours were always much higher. We did have all those problems with high inflation, we did have problems with risk premia, we were looked upon very poorly by the rest of the world and there was nothing great about having different bond yields to the US, in our experience, because we were always so much higher. Where we are now is a sign that we have made a lot of improvement, and we are pretty close to world's best. Some people say, 'Well, in that case, why don't you have bond yields lower than the US?' That is not necessarily a great thing either. Look at Japan. If you want to have really low bond yields, have some deflation. So where we are at the moment is not a bad position to be in in terms of bond yields. I think it is a sign that we are taken reasonably seriously—as a serious government with good government paper.

Mr LATHAM—Just further on this question of independence and specifically Reserve Bank independence, I want to come back to the point or the discussion we were having earlier on. You made the observation that, if the bank is independent, it is easier for politicians, particularly the government, to get stuck into you. It is almost like you are inviting that as a proof of independent credentials. The Treasurer, Mr Costello, made a similar point last week because of the current controversy. But isn't it reasonable for someone in the markets looking at this to think, 'Well, if the Treasurer says something or the Prime Minister says something about monetary policy, surely this will be reflected in the participation and vote of their representative on the Reserve Bank board—the head of the department of Treasury—Mr Evans.' How can you ever be seen as truly independent as long as Mr Evans sits on your board?

Mr Macfarlane—You are starting to open up the great issue of the Reserve Bank Act, the structure of the Reserve Bank board and the Reserve Bank mandate, which I do not particularly want. I am comfortable with the current arrangements we have. They may not be perfect, but I am comfortable with them because they have broad community support. All I can say on that issue is that I think we have made the right monetary policy decisions. I do not think our monetary policy decisions have been deflected in any way because of that fact.

Mr LATHAM—The Reserve Bank recently prepared a position paper on central bank independence, and it revealed that Mr Evans is in fact the only head of department of Treasury in the OECD that sits on a policy making central bank board. He is the only one in the OECD. Is that the case?

Mr Macfarlane—I am not aware of any position paper being prepared by the Reserve Bank on that subject.

Mr LATHAM—Finally, can I put a flip side argument about independence? There is a provision in the Reserve Bank Act, section 11, that if the government thinks you are doing a terrible job, what they should do instead of going through the media is to table the reasons in parliament and to seek a parliamentary direction on monetary policy. Just thinking about that, where would the government get advice on how well you are performing your duties? Wouldn't they rely on independent advice from the head of the Department of Treasury? If he is actually a member of your Reserve Bank board, how can he ever give government advice about a very legitimate clause in the Reserve Bank Act?

Mr Macfarlane—We are getting very hypothetical. I think if it ever got to that state, the government would have a pretty clear idea of its own views, and it would not be necessarily sitting there and waiting for a public servant to give it a piece of advice. I think if it ever got to that state, it would be pretty cut and dried. The government would have to have very strong differences of view with the Reserve Bank. We are certainly nowhere near anything like that at the moment. But I think that is very hypothetical.

Mr PYNE—Mr Macfarlane, the premise of Mr Latham's questions is that, like Gerald Ford, people cannot chew gum and walk at the same time. I think it is probably fair to say that Mr Evans is probably capable of doing both and being able to give objective and dispassionate advice both to the Reserve Bank board in that capacity and also in his capacity as head of the Treasury. You said before that the last few months had indicated the genuine independence of the Reserve Bank board because of the fact that there were arguments in public and that the government did feel that it could make statements about monetary policy. Do you also agree therefore that Mr Evans's position does not in any way prejudice the Reserve Bank board's decision making capacity?

Mr Macfarlane—I have already said that. I do not think that he has prejudiced our ability to make decisions. I think we have made the right decisions.

CHAIR—One area that I would like to open up is your role with the Payments System Board. There has been a recent study in the UK—the Cruikshank report, which you would be aware of—talking about a review of banking services and particularly the commercial banks' credit cards. That report was very critical of matters in the UK and the banks in particular. We obviously have a similar system here in Australia with credit cards and the fact that the banks do control them, and they do put significant charges on retailers, particularly smaller retailers. It is an area that is totally unregulated. I just wonder whether the bank has had a look at this. Do you see some problems in the way that these credit card charges are being levied at the moment?

Mr Macfarlane—It is a very interesting subject, and it is one that we are looking at. In fact, it is one where we are in a better position here in this country to look at than in most other countries, specifically because the Reserve Bank has this additional board—the Payments System Board—with legal powers to regulate and legal powers to get information. The Cruikshank report to which you refer was handicapped throughout because it could not get information on the size of the so-called interchange fees. So we are in a much better position to look at this, and we are currently undertaking an examination. That is all it is at this point; it is an examination. We want to find out what goes on in this area. It is intensely complicated and it covers three streams: firstly, credit cards; secondly, debit cards or EFTPOS; and, thirdly, use of ATMs. They are all related in that the banks that are involved pay fees to each other, called interchange fees. We are in the process of looking into this and finding out exactly what is happening and whether the consumer is getting a good deal—in other words, whether the thing is efficient and whether the charges are fully reflecting the obviously massive reductions in costs that have occurred because of the improvements in data processing and electronic systems.

At this stage it is only an inquiry, although you probably will be aware that two other things are happening at the same time. One is that a Senate committee is also looking at the subject and, secondly, that the ACCC have received a complaint and they have gone back to the banks and to Visa and to Mastercard, and said to them that, as far as they are concerned, there does appear to be a per se case—I think that is the term—of price fixing. So the banks and the card cooperatives have the choice of either going back to the ACCC and asking for authorisation, which means that they accept that it is price fixing but it is in the national interest, or they take the ACCC to court and say they disagree—that the ACCC has made the wrong decision. At this stage we do not know what the response will be, but that is unrelated. All that work that the ACCC is doing, this so-called enforcement, is unrelated to what we are doing. We are simply trying to find out what is going on and what the flows of fees are.

CHAIR—Would it be reasonable to ask that you report to the committee when you have something?

Mr Macfarlane—We will certainly be reporting, yes. I am not sure of the timetable—we may well be reporting in a couple of months time, so it may well be before the next committee hearing—but we are certainly happy to keep the committee informed.

CHAIR—On this interchange, are we talking of a figure of some $600 million? Is that a fair estimate?

Mr Macfarlane—I have seen that figure quoted, I cannot vouch for it. That figure of $600 million is a different one. The merchant service fees are even bigger. Interchange fees are just fees that banks pay each other. Merchant service fees are what the merchants pay the banks for providing the credit and debit card facilities for that merchant.

CHAIR—Do you have a figure or an estimate on that?

Mr Macfarlane—Steve was just pointing that one out to me. The merchant service fee was $935 million. That will always be quite a lot of money because they provide a very useful service. If you are a small business—a shopkeeper or something—you have to have access to the credit card and EFTPOS network in order to maximise your sales. So someone who comes along and provides that will obviously expect to be paid for that.

CHAIR—But the point of your inquiry is obviously: is that a fair price?

Mr Macfarlane—Our inquiry initially is not even about the merchant service fees; it is about the interchange fees. It gets very complicated, but interchange fees are the network of fees that banks pay each other.

CHAIR—Has any work been done on the merchant service fee?

Mr Macfarlane—That would be the logical next step.

Dr SOUTHCOTT—There has been a bit of academic work in New Zealand about the concept of a common currency. I believe your counterpart Don Brash will be giving a speech today about the concept of a common currency. Has he forwarded you a copy of the speech?

Has the Reserve Bank done any work on looking at a common currency? What is your assessment of this idea?

Mr Macfarlane—We take a pretty low key role in this because it is mainly of concern to the smaller of the two countries. The smaller of the two countries is going to get the benefits or pay the costs. The smaller of the two countries will have to worry about loss of sovereignty. For the larger of the two countries, I think the only decent thing to do is basically to sit back and to let the smaller of the two countries get on with their own decision. We are aware of it, but we actually would think it presumptuous to jump in with our opinion. I think it would also probably have been very counterproductive—the last thing New Zealanders would want to think is that someone in Australia was trying to make a takeover for them.

Dr SOUTHCOTT—So you have made no assessment of a common currency?

Mr Macfarlane—No.

Ms BURKE—I want to wander back to the independence of the board. Dr Southcott raised before the notion of the voting procedure that the board undertakes, and you said that you could not comment on the votes taken by the board. The last time you were before us I asked about the board providing the minutes of its meeting, and you have probably seen the stuff in the press recently comparing you both to the US and to the UK. I do concede that the page summation that you provide following the board meeting is probably quicker and more thorough than the minutes that they provide. Do you think that now, given the current speculation about the reasons behind the banks' interest rate rises, you do need to provide a more in-depth analysis of the actual goings on in the board?

Mr Macfarlane—No, I do not think we need to. My view has always been that we want to be transparent and we want to provide useful information when it is useful to people. Every central bank has a different set of arrangements. One of the things that happens is that a lot of observers come along and ask, 'Why don't you do such-and-such like so and so? Why don't you have minutes like the Fed or the Bank of England? Why don't you have a press conference like the ECB?' Everyone is slightly different. Where we stand in the international spectrum is that we have the most detailed account of anyone, at the time immediately the change is made. If you look at the other countries, there are really only a few sentences in some cases or a paragraph which is a pro forma which does not vary very much from meeting to meeting. We are the only ones who make a serious attempt. Most people I think appreciate that, although I did hear someone say that they thought that we just said that 'interest rates had gone up because they had gone up'. That is clearly not true. You only have to look at what happened in April. We have people out there who spend whole paragraphs analysing every sentence in what we put out, so at the moment my feeling is that that is a more valuable service. It is certainly something that people take notice of—too much notice in many cases.

The other alternative of putting out minutes has got advantages and disadvantages. Its advantage is that it is longer, you can spend a lot more time; its disadvantage is that it takes time. You cannot have a meeting and put out minutes until someone has written the minutes and they have been given to all the members to give their opinion, to say, 'No, I didn't say that,' or, 'No, we spent more time discussing this than that,' or, 'Why didn't you mention this?' You cannot mention everything; it has to be a selective thing. The problem with minutes is, firstly, it comes out later—in the case of the US about six weeks later; and in the case of the Bank of England, it is up to a fortnight later—and, secondly, I think it is actually easier. It gives the people who are putting the minutes together the benefit of hindsight. When you are deciding which things you really want to emphasise, you know what has happened, you know how the market has reacted. You know what the press has said, and you know what the politicians have said. It is not the same discipline as having to say honestly what you think at the time before you have seen what the reaction is. My view is that what we do is actually more valuable and there is a bigger discipline on us. But opinions differ, and I do not have ideas that are set hard and fast on that one. I think what we do is better, but I would not die in a ditch over it.

Ms BURKE—Given the incident that happened back in February with the unfortunate early release of the statement via email, can you now tell us what you have put in place to put out that information? There is a view around that the email list was only shown to the Treasurer, and that the individuals on that list have now altered since that event occurred. There were also some media reports about the individual who was supposedly the cause of the email going out and her demotion and subsequent reduction in salary that caused a bit of a flurry in the press. I wonder whether you would like to comment now about how that is now being released so that we are getting an accurate reflection of what has taken place.

CHAIR—We did canvass this last time, I think.

Ms BURKE—But there has been some—

CHAIR—That was in March. If there is any follow-up—

Ms BURKE—I am just wondering. If you do not want to make a statement—

Mr Macfarlane—No, I am happy to make a statement. Basically our solution to it was that we have stopped being as helpful as we used to be. That is how we got into trouble, by being helpful. We have looked through all the things that we send out, and we have worked out what is absolutely necessary to send out. And so it is a much smaller list. The list that you referred to no longer exists. The reason we did not put out a public record of all the names on the list is that, to the best of our knowledge, most of them—probably all but one or two—did not act on it and if we put their names out, it would somehow or other imply that some people would think they had been doing insider trading or something. So we did not put it out. But the person concerned, the operative who did it, was moved to another area. She was not demoted; she was moved to another area.

Ms BURKE—There were also some media reports that the Prime Minister was looking for you to come out and make some more statements, to be giving some more addresses, so that, if I can summarise what the article, you can cop the flak for the decisions about interest rate rises, and not the government. Was there any substance in those reports? Do you intend to make any more public statements outside this forum?

Mr Macfarlane—I do. I make speeches when I have something to say. I think this is a very important forum. This is really the best forum of the lot. But I also make speeches if I have some particular thing I want to say. I do not really feel that I want to be up there every week or fortnight making statements, because there are too many people going through the entrails and saying, ‘He used the word “strong” this time, now he has used the word “solid”,’ and all the textual criticism that goes on. I think too many speeches would probably be destabilising, but we do quite a few.

Mr PYNE—I have a raft of questions on margin lending which can wait until other people might want to put questions on the same subject—or is it a different subject?

Mr ALBANESE—It is related. My question goes to the relationship between the bank and perceptions of the market as to its political independence. One of the leading international market commentators, David Hale, the Zurich group’s chief global economist, said on ABC radio on 11 April:

Clearly because of the political background, the Reserve Bank doesn’t want to link interest rate hikes explicitly to GST, because that in turn could embarrass the Government and cause controversy with the Federal Treasurer. But there’s no doubt that when you have that big a price change about to happen, you’ve got to be concerned about possible knock-on effects.

Governor, are you concerned that there is a market perception there that the political independence of the bank has been eroded in recent times?

Mr Macfarlane—This is something that I am very happy to comment on. There is a view that comes out from time to time from critics of the Reserve Bank that says something along the lines of ‘you cannot be independent if you are not putting forward this particular argument,’ and the particular argument is the one that that critic actually favours. So we have seen that in two directions. First of all, we have seen people who would like to think that the rise in interest rates occurred because of the GST, and they get very disappointed when I say, ‘ No, that is not the case. Interest rates would have gone up whether there was a GST coming or not.’ They get very disappointed when they hear that and they say, ‘Oh well, that shows you are not independent.’ But maybe it is not—maybe it is because it is just wrong and I do not want to say something that is wrong. The other one is the ‘Why aren’t you criticising fiscal policy? Fiscal policy must be making the Reserve Bank’s job so difficult; you ought to be out there criticising it.’ The answer is that we are not saying that, because it is not true. The government could put up taxes by another $10 billion and have a $10 billion surplus, and that would not make our job easier.

Mr LATHAM—Could I just raise this point: you talk about the words of critics. What about your own words? By my own count, the semi-annual statement mentions the government’s tax reform package no less than 31 times, mostly in the context of inflationary risk, capacity constraints in the housing industry and second-round wage effects. Isn’t it just absurd for the bank to continue to say the GST is having no impact on prices inflationary expectations and monetary policy?

Mr Macfarlane—We have not said the GST is having no impact. For example, we know quite clearly that it is having an impact already on the housing industry. We know that a whole lot of extra houses are being built and a whole lot of extra alterations and additions are being done as people try to get in before the GST, and we talk about that. We know that there are a lot of other areas where it will have some effects. We are expecting, for example, that some ordinary consumption that would have taken place in the September quarter will be moved forward to the June quarter. We talk about those things. All we are saying is that we have not tightened monetary policy because of the GST. That is what we are saying. We are saying that the GST is doing a lot of things to the economy. We are saying it is going to make it difficult for us to judge exactly what is happening to inflation, but we are not saying what you want me to say: that we tightened monetary policy because of the GST. And we are not saying that, because it is not true.

Mr LATHAM—But isn’t that just fantastic to say that the GST is having inflationary impacts but it is not a reason in the formulation of monetary policy? How can anyone believe you?

Mr Macfarlane—Where are the inflationary impacts you are talking about?

Mr LATHAM—It is mentioned 31 times in your semi-annual statement, so it is getting up towards—

Mr Macfarlane—We did not say 31 times that it is having an inflationary impact. I do not think we have said that at all.

Mr LATHAM—There are repeated references in the context of inflationary risks, capacity constraints in the housing industry, which is a big part of the Australian economy, and repeated references to the second-round wage effects. If that does not total 31 times, are there other points in the semi-annual statement where you are pointing to a deflationary effect from the GST that counterbalances the inflationary impacts that you are pointing to? Can you answer that question? What is the deflationary effect of the GST?

Mr Macfarlane—The only effect you are referring to is when you say we mention the GST in terms of inflationary effects. To the best of my knowledge the only reference is when we have been asked, ‘Why has the Melbourne Institute survey of inflationary expectations gone up to this high a level?' We have said that is because they are being asked about what is going to happen over the next year, and the next year includes the GST. That is our comment on the relationship between the GST and inflation, but that is a price level effect. We are not saying that the GST will lead to higher inflation; we are saying it will lead to a lift in the price level and that that has got into this particular measure of inflationary expectations.

Mr LATHAM—Is there a possible deflationary impact from some part of the GST? That is the question I asked.

Mr Macfarlane—The answer is no, I have not been able to identify a deflationary effect.

Mr ALBANESE—To follow on from that, isn’t it impossible to distinguish between GST related price increases and underlying inflation from other causes?

Mr Macfarlane—What are you referring to? After the event? After the GST?

Mr PYNE—After 1 July.

Mr Macfarlane—I think opinions will differ. There will not be an absolutely 100 per cent irrefutable number. There will have to be a few assumptions made, but I think people will know reasonably well how much of it is the GST and how much of it is underlying inflation. It will be tricky for a while, but the September quarter figure is going to have the big GST effect in it and that quarter will be difficult. But as each quarter comes along, you will be able to see the quarterly result which will not have been affected by the GST, because the GST really only affects one quarter.

Mr ALBANESE—Allegedly prices will come down after the first quarter.

Mr Macfarlane—You are right, they will actually be lower than the trend, but it will still give you a reading. It will still give you a reading in the December quarter, and in the March quarter you will get another one. It is true that it should be lower than the underlying because it will still be benefiting from the lagged effects of the reduction in the wholesale sales taxes, so you will have quarterly things to look at. It is just the 12 month ended which will be affected for a 12-month period, but you will be able to get information from the quarterly ones, and you will be able to get information from wages. There will be a lot of sources of information. But it will not be absolutely irrefutable: here is the figure, X dot Y.

Mr ALBANESE—Isn’t it true also that part of the increase in inflation which we are seeing now could be attributed to an anticipation of the GST?

Mr Macfarlane—It is possible that there is a little bit in there from the housing sector, but I do not see it really from anywhere else. It is just possible that some of the housing could be, because the housing sector is operating on full capacity in anticipation of GST. That is possible.

Mr LATHAM—On this question of inflationary expectations, you mentioned that you rely on the research from the Melbourne Institute-Westpac survey. Do you agree with their conclusion that the major factor driving inflationary expectations appears to be the expected impact of the 10 per cent GST on price?

Mr Macfarlane—The question they ask people is: what will be the rate of inflation over the next year? And over the next year, they are quite correct, that will be the major impact in one year—a lift in the price level.

Mr LATHAM—So you agree with their conclusion?

Mr Macfarlane—Except that they expressed it rather loosely. They should say, ‘The lift in the price level that will occur in the next year as a result of GST.’

Mr LATHAM—And that leads into inflationary expectations?

Mr Macfarlane—If you ask me, my inflationary expectation for the next year—

Mr LATHAM—No, I did not do that. I asked about the Australian public.

Mr Macfarlane—I think I would be very similar to the Australian public. If you ask me for my inflationary expectation, about what I thought was going to happen to inflation over the next year, I would have the GST in there because I know it is going to happen.

Mr PYNE—With respect to margin lending, which is a part of the semi-annual statement, it says in the semi-annual statement, ‘margin loans outstanding from banks and brokers rose from $2 billion in September 1996, when the Reserve Bank began informally collecting this information, to $6.3 billion in the March quarter of 2000.’ Could you indicate to us, firstly, why the Reserve Bank started to collect the information and why it had not been collecting it before; and, secondly, what you put down as the reason for such a dramatic increase in that period, September 1996 to the March quarter of 2000? I think this is in Dr Grenville’s area; he so far has remained very quiet in this hearing.

Dr Grenville—I assume you have just taken pity on me, sitting here in the outfield. Finally you have thrown a ball in my direction, so let’s see if I can catch it. I think the reason why we started to take some interest in this is the fact that other people did too. We felt the need to assure ourselves that this was not something that we or the prudential authority should be worrying about.

I think when we did look at it, we got a fairly clear answer. That was that margin lending, as such, is not something that we should worry about in a macro sense or something that the prudential authorities need to worry about from the point of view of system-wide stability in the banking system because it turns out to be so small. It has risen extremely quickly. It has gone, as you say, from $2 billion to $6½ billion in just a few years, just three years, and in the last year it rose by 50 per cent. But, in absolute terms, it is quite small.

The other reason for not being too fretted about it in a macro sense is that, in the course of talking to people about the margin lending, the very clear message we got was that those who were borrowing on margin were generally borrowing amounts like 50 per cent. In other words, there was a safety margin. There was the opportunity for the asset that they were funding to fall very substantially, without this either triggering any debt problem or even necessarily triggering any margin calls. So, why did we have a look at it? It had the potential, at least in a general sense, of being worth looking at. But, as it turns out, when we looked at it, it was quite small.

The other thing that should be said about this particular area is that the thing we looked at was a very specific thing called margin lending; in other words, things that were very closely associated with this terminology. But money is fungible. In the end, we do not know exactly what people are borrowing for. It is much more difficult to answer a wider question: are there people who are borrowing too much? But, on the narrower issue of margins, we looked at it and thought it was not a system-wide issue.

Mr PYNE—At what level do you think margin lending could pose a risk in the lending sector?

Dr Grenville—When it is running at one per cent of the sort of measures that you would want to relate it to—in other words, household assets or GDP or market capitalisation. That is a long way below what would be a concern in a macro or a prudential sense. Just where people would start to get worried does seem pretty hypothetical when it is so small.

Mr Macfarlane—Can I just mention this historical comparison? Steve said it is one per cent; I think it is 0.9, virtually one per cent. In the US it is twice as high as that, two per cent. In 1929 it was 22 per cent. So it has to go a long way before it has a serious macro implication.

Mr PYNE—Why is Australia so much lower than the United States? What is the reason for our lack of interest in margin lending?

Mr Macfarlane—We are just more cautious people; I think that is it. Do you have a better explanation? We probably do not have it shoved down our throats as much as in the US, where the marketing of these things is very aggressive.

Mr SOMLYAY—Mr Macfarlane, the paper that you gave us on bank fees: I wonder whether you could run us through it and point out the highlights that we should be looking at.

Mr Macfarlane—Since Dr Grenville did such a good job on the previous one on margin lending, I think I will hand that one to him as well.

Dr Grenville—This is what always happens: the ball starts coming your way all the time. In a way, it is a thankless task to take on the task of explaining this. In the process, you seem to be describing what banks are doing, and banks have always done something to all of us that makes us think that they have been unhelpful in one way or another. But the general story on bank fees and, in particular, their relation with margins I think is quite a positive story. I think it is a good development and a natural development and something which is moving us towards greater efficiency that banks should impose fees which are related to their efforts to recoup the costs of having payment services or administering deposits. So, in principle, it seems to me to be an okay thing for banks to do—to move towards charging for things which cost money for them to provide.

As for what they have done recently, the fees, as this paper shows, have risen quite quickly—13 per cent or 14 per cent a year. But what needs to be said is that, in relation to the services provided by those fees, if we try to relate the fee to the service—for instance, with the volume of transactions which are provided, or with the growth of loans or deposits—we find that the increases have been relatively small. There has been almost no increase if you take into account the increases in transactions and so on which they are doing. The thing we notice, I think, is that they are looking particularly at their deposit base and trying to get the charges there in a proper relation to the costs in that area, and that the increases have been less in the area on the loan side.

The really powerful point to make is that, even though they have been putting in place charges to recoup their costs in this area, if we try to put that in proportion to the services which they are providing and then try to relate it to the fall in margins, it is clear that the rise in fees has been relatively small compared with the fall in margins. We see, for instance, both for households and for business, the fall in margins over the last five or six years has amounted to over one per cent. If you think of that in taking a loan, the margin which the banks have been charging has fallen by more than one per cent and the absolute size of the fee is actually smaller than that one per cent. So the fall in margins has been greater than the fee that exists now—and, of course, some of that fee existed before. So one never wants to take on these arguments in too Pollyanna a type of fashion because I am sure it would be possible to find people who do come out of the generality of this paying more. But the general direction in which this has been going seems to be satisfactory—and that comes from an institution, the Reserve Bank, which was one of the earliest to highlight this issue.

Ms BURKE—You may have seen the CANNEX report that has gone into the bank fees and charges. I think one of the surprising stats is that, at $10 billion, bank fees and charges are approximately two per cent of GDP; and that 2c in every dollar spent in Australia somehow winds up as a bank fee and charge. Don’ t you think there is some sort of justification of the community out there being a bit outraged at how much it is costing them to do their banking? The report finds that, on average, it now costs you 43c to deposit cash and $1.66 to withdraw it. If you look at the annual reports, the actual net interest income of the banks versus their non-interest income has gone up substantially, just looking at where their profit margin is coming from.

The other interesting aspect is that anecdotally—and I am not sure that we would get the banks to tie this down—NAB is reported to have said that it costs banks less than 2c per transaction for online banking, ATM costs more than 20c, phone banking costs between 50c and 60c and a branch transaction costs well over a dollar. Obviously that relates to staff. It was put before the PSA inquiry back in I think 1996 that banks were charging fees to ensure that customers took the cheapest option for them—that is, it costs you a lot more to go inside a branch than to stand at the ATM. Given all that and the research that you have done yourself, don’ t you believe that there should now be some impost upon banks to ensure that customers are not being penalised having to deal with them, given that we must deal with them, and that the most disadvantaged in our community—that is, pensioners, who receive something via the government—must interact with a bank because they are either given a cheque or their allowance is paid by direct debt into an account?

Dr Grenville—I feel like saying that we should get back to talking about monetary policy. All those are important issues. Judging the size of these things, the thing that always strikes me when you look at the breakdown of the GDP is how much we spend on services. GDP is not all just lumps of steel and wheat. We spend a huge amount on getting other people to do something that makes our lives a bit easier. Banking services is one of those things that do make our lives a lot easier. We do not have to jump in a plane and go to Brisbane when we owe someone in Brisbane some money. That is a trivial example, I suppose. The real issue is: do these costs seem proportionate to the job that is being done? I think of it as being quite a big and difficult job that the banks do. So it does not amaze me when surveys come up—that was a wider survey than ours—with reasonably big figures on what is required to put that service in place: the people and computers and so on.

Then there are banks’ profits and our efforts to understand how it is that, in a world where their margins are coming down, their profits are still really quite good. The answer to that is that they have been cutting their costs quite markedly over the last 10 years in various ways. That I think is the direct addressing of this question: are we paying them too much for this service?

The answer is that they are trying to provide that service more efficiently. Is it the cheapest option for them? My guess is that it is because it seems to me a sensible thing for the banks to do to say, ‘It does not cost us much to provide a service through an ATM, but it costs a lot more to provide it at the counter; let’s move in the direction of putting the charges where the costs are’—and not just because they want to be perverse, but some people will actually respond to that.

For my part, I almost never go into a bank now. I know that will not suit everyone. As I say, this job of defending or explaining the banks is a thankless one because there will always be examples of people who do not want to use the ATM. But, by and large, I think we have to accept that, if they signal to people that the costs are lower for an ATM than coming to the counter, that has to be part of the process of making the services more efficient, and we have to benefit from that.

Ms BURKE—Except for the staff who lose their jobs, I suppose is my argument. Also, there has been an actual 20 per cent to 25 per cent reduction in RBA staff recently and the closing of your banking functions as part of the government’s move to outsource in opening up the departments to competition. Firstly, do you believe that this is giving taxpayers value for their money; and, secondly, do you believe that you will be losing the skills that the bank could have in banking practices, given that you are meant to be a regulator also of banking and that you will not have in-house bankers any more, people who do bricks and mortar type transactions?

Mr Macfarlane—The main outsourcing or the main loss of functions of the Reserve Bank is actually coming from state governments who have taken their business away from us. The economic viability of the state branches depended to a surprising degree on state government business. As the state governments have taken their business elsewhere, it has just not been possible to keep the branches going. Our branches do not serve the public; they only ever serve the federal government or state government, and it never did actually require very many people to do that. Once the state government business had gone, we ended up having these branches with 15 people or so in them and yet handling an amount of cash which was many billions and billions of dollars a year. It was just not viable to have such massive amounts of money being handled by these tiny little branches. We hung on to the bitter end but, regrettably, we have had to close them. To date, most of the action in terms of taking functions off us has actually come from state governments, not from the federal government—although that may come.

Ms BURKE—I was about to ask: has any of that happened?

Mr Macfarlane—There have been some, but small ones, not the big ones. Some of the small ones have gone to tender, as well as the Department of Finance itself. I cannot remember the other ones, so I will not quote them because I am not 100 per cent sure of what they are. As for our expertise, we are not actually a regulator of banks. APRA is the regulator of banks. The only area where we are in that is in the payments system area. We never were in that area. We never had credit cards or debit cards or ATMs or any of that sort of stuff.

Ms BURKE—But you did have clearance facilities.

Mr Macfarlane—Yes, and we still run the clearing system, the wholesale clearing system. We still run the RTGS system. At the wholesale level, the really high value wholesale level, we are still involved. That is the bit that is important to us; that is important for systemic stability. We are involved there and we understand that. Then there is the retail payments system, which we have responsibilities for. We never had direct hands-on responsibility other than cheque clearing, which is an old-fashioned part of that. It is a very, very complex thing, this retail payments system. We have very, very good people working there. It has become almost an exciting, intellectually glamorous area to work in now. So I do not think we are suffering a skill shortage there.

CHAIR—The Payments System Board: the last time you came before us you were talking about the cheque clearance times and two of the majors had not met the three-day target. I wonder whether you could give us an update on that.

Mr Macfarlane—I do not think it has changed. I might be wrong; I have not briefed myself on that. I do not think it has changed. But we keep the pressure up in that we will be publishing it in our Payments System Board annual report. It will have the list there and you will be able to see which banks will guarantee you that and which banks will not. We could make it more public if we wanted to: we could put out a press release.

CHAIR—When will that be published?

Mr Macfarlane—That comes out in September.

Mr ALBANESE—I have just a couple of things on the banking issue, one direct and one indirect. Directly, I think the concern that we have had, something that we have all agreed on re the banking sector, access, fees and charges and bank closures, et cetera—that whole issue—is not so much a concern about fees and user pays but the distributional impact of the banks' changes. At the end of the paper you have produced for us today, there is a statement about the distributional impact being worse against people without a loan but that those with low balances and high transactions would not have benefited. Can I ask whether we could have, if possible, some more data on that, some more impact on that? The concern that we have, particularly in terms of the rural banking inquiry that we did, is exactly that: that some people are being left behind. We would be interested in that. That is a request rather than a question, I guess.

CHAIR—Just on that point, Mr Macfarlane, are you happy to do that?

Mr Macfarlane—I am not sure. I will have to think about that one. We are not a consumer protection agency at the Reserve Bank. We got into this area at the request of the committee—in fact, it was some time ago at the request of the committee—because we first started looking at margins. As you know, we did a lot of work on that. We are very pleased we did it, and we think it was valuable and it is widely quoted. That was because 'margins' was really central to the monetary policy issue. You will remember that we were coming out of a recession and we seemed to be coming out slowly. One of the issues was: well, banks aren't out there aggressively lending enough. That is how we got into that, because it was central to our monetary policy deliberations.

Once we got into that, we ended up getting on to fees, which were not quite so central. But access is so far removed from the responsibilities of the Reserve Bank; it is really a consumer protection issue. It seems to me that we should hand the ball over to someone else, some part of the government that is responsible for how consumers are being affected. This is really not central to our work. In fact, I do not know how we would go about doing it. The sort of person who is going to do that will have to do surveys. It is very different sort of work. We want to be as cooperative as we can, but we do not want to move outside of our central responsibility and end up doing some other government agency’s work.

CHAIR—So you are taking that question on notice then?

Mr Macfarlane—Yes.

Mr ALBANESE—Bankers I think perform a very important role in terms of making us seem relatively more popular as politicians in terms of community expectations. But there is the issue of remuneration of CEOs of banks, et cetera—and, in the finance sector in general, there is the much-vaunted AMP example where perhaps other Australian workers would like to be rewarded for failure as well. In terms of the impact that is having on wages and in the context of your earlier comments about the need for wage restraint with a GST coming in where people see that inflation will be increasing, do you have any comments about the legitimacy or otherwise of the ACTU as a peak body, but workers in general, having a look at the remuneration packages of CEOs of banks in particular—that is, those who seem to be rewarded for cutting staff and increasing costs, as far as the general public is concerned—and the impact that that has in a macro-economic way in terms of wage expectation and then feeding into inflationary impacts?

Mr Macfarlane—I have been asked this one before and my answer is going to be rather similar. I cannot understand certainly the severance packages; they seem to defy all logic to me. I think you would be better off talking to a lawyer who might understand that because it does not seem to have any economic or incentive effects. As far as I can see, if we read the newspapers, it is not confined to banking or insurance. I think some of the wonderful new economy seems to have some of these same characteristics, if we are to read about events in the last week. I do not understand it. It does not appeal to me. It seems extraordinary that people who have either failed or who, even if they have not failed, are going to provide no further benefit to you should be rewarded with these large sums of money. So I am perfectly happy for anyone to do an inquiry into it. In fact, I would be very interested to find out exactly why these sums of money are as high as they are. It is not up to the Reserve Bank to do it. But, if the ACTU wants do it, good luck to them.

Mr LATHAM—Just for the record, what did you learn out of the Y2K experience—not that we will be here over the millennium to do it again.

Mr Macfarlane—I am glad someone asked that question. We learnt that nothing bad happened. The question is: did we take overinsurance? I think that is the issue. We paid an insurance premium to make sure nothing happened, and nothing did happen. I think someone is going to say, ‘Wouldn’t it have been nice if something bad had happened somewhere else so we would have been able to say, "Ah, just as well we did all that"?’ But it does not appear that anything particularly bad happened in those countries that we were being warned were going to collapse. So it may well be that the world as a whole paid a slightly higher insurance premium than they needed to to get through Y2K. But you really have got not much choice about it when you have people who know a lot about this area—and I do not know how they said it—who might have said, ‘There's a one per cent risk of a catastrophe.’ If that was the situation, you had to actually take out some insurance.

The insurance was not really all that costly. I think it tended to be overstated. I think people put whatever money they were spending in their IT departments down that year in saying, ‘That was all to cover Y2K.' I think when we do our annual report, we will be able to enumerate how much it actually cost us. There is a little bit in extra staff costs and overtime, and we are holding higher stocks of bank notes than we need to, which we will run down over time. But there is an inventory cost in holding more bank notes than we needed to. I do not think it will turn out to be a huge sum of money. I think, given the risks that we were being warned about, we really had no choice but to take all those precautions. But, with the benefit of hindsight, I need not have been at work on New Year’s Eve; I would have been better off at a party.

Mr LATHAM—There is a very funny story of Michelle Grattan leaving a New Year’s Eve party to go to your press conference, so it must have been one hell of an event. Was Y2K a factor in the delaying of the second rate rise into the New Year?

Mr Macfarlane—No.

Mr LATHAM—Not at the time.

Mr Macfarlane—No. I think it was talked about in the US as a factor, but it was not a factor here.

Mr LATHAM—My final hurrah on monetary policy—and I found this at the bottom of my pile, so I think it is for the purists: in your agreement with the government, the bank adopts the objective of keeping underlying inflation between two and three per cent, on average, over the cycle. Do you take the cycle to be a nine-year period now; if so, does not the concept of averaging lose something of its meaning? In reading all your words, I noticed today in your opening statement you actually said that the inflation target says inflation should average between two and three per cent in the medium to long run—not over the cycle, but in the medium to long run. Is this a small but significant change in emphasis?

CHAIR—In the opening statement; the other words were added in the spoken statement.

Mr Macfarlane—When I read it out, I also said ‘or if you want to use the term "over the cycle" you can use it’. The ‘over the cycle’ was just a shorthand way of saying medium term. It never really meant that you had to get each cycle right. It was just a way of recognising that, just as there is a cycle in economic activity—and we hope that it is a relatively damped one these days—there does tend to be a cycle in inflation. When we got the wording for our original agreement, what we were really trying to do was distinguish our system from some of the more rigid ones. We wanted to say that ours is more flexible; that all you have to do is get the average right in the long run, or over the cycle, as opposed to the earlier models—those of New Zealand, Canada, et cetera—where you had an upper and lower band and you had to stay within that upper and lower band. So, in the early phases we used the term ‘over the cycle’, but we could just as easily have used the term ‘in the medium term’ or ‘in the long run’.

Mr LATHAM—But does that then mean you are working on a nine-year average?

Mr Macfarlane—No, we are not working on any particular year average. I suppose if you really wanted to be more precise, you would just use the term ‘in the long run’. You would forget about medium runs and you would forget about cycles, and you would just say, ‘In the long run we want to average two-point something’.

Dr SOUTHCOTT—Mr Macfarlane, you have really addressed this in some of your previous answers, but the issue of bank fees is one that is of great interest to members of the committee and especially the people we represent. However, I do feel that it is a little bit peripheral from the central responsibilities of the Reserve Bank. So this is not really a question but more of a statement: while we can talk about it and look at it with the Reserve Bank as a matter of interest, it really does not fall within your area of responsibility.

Mr Macfarlane—I think when it was calculating financial ratios and that sort of stuff, it was. But, if it is to do with access—how many pensioners have to go how far to find a bank—we cannot do that. We really do not have the expertise to do that.

Ms BURKE—According to the press, I am here on a learning expedition today—they beat up on us too, so feel pleased about that. Do you believe that the central bank can actually make an exchange rate—set, make, create?

Mr Macfarlane—Yes, you can. You can have a fixed exchange rate regime, which we had for a long time. You can have that sort of regime if you want it—and we do not. We think that a floating exchange rate is a better exchange rate regime. If you have a floating exchange rate, yes, you can have an influence on it. You can cause it to be different from what it would otherwise be both by your setting of interest rates or by foreign exchange intervention. So you can have an influence. But the last thing we would ever want to do would be to nominate a figure and say, ‘We want it to be that or to be no higher than that or no lower than that’. If you did that, you would be setting up exactly the same sort of destabilising speculative pressures that you had with a fixed exchange rate. So obviously our activities do have an influence on the exchange rate, and the exchange rate has an influence on how we choose to go about doing monetary policy. But we cannot set one, other than by going back to a fixed exchange rate—and we do not want to do that.

Ms BURKE—Therefore, where does smoothing and testing of the rate begin and end?

Mr Macfarlane—Smoothing and testing is rather an old-fashioned term that we used in the very early days of floating the exchange rate. We do not use that term any more.

Ms BURKE—Therefore, you do not use the concept any more?

Mr Macfarlane—We still retain the capacity to do foreign exchange intervention. We believe that foreign exchange intervention, if used sparingly and intelligently, can be effective. So we still have that on the table.

Ms BURKE—Currently there are amendments to the Reserve Bank Act going before the next session of parliament; specifically these are changes to 66 through to 71, which are reflective of staff appointments and terms and conditions. Have you made any comment on those changes? Also, how do you seem them impacting on staff and their terms and conditions?

Mr Macfarlane—I do not think it will have any impact at all. I cannot remember what the details are. One of them is that they do not have to be an Australian citizen any more, for example. I do not think that will have a big impact. It is just a matter of simplifying the legislation. We are not trying to get something through because we have an ulterior motive and we want to go and do some particular thing to the staff. It is just a matter of simplifying things.

CHAIR—On behalf of the committee, I thank Mr Macfarlane, Dr Grenville and Mr Stevens very much indeed for coming before the committee today. I think this has been a very valuable day. Before concluding the hearings, I would announce that the next hearing will be held in regional Australia. Mr Macfarlane has certainly agreed to and endorsed that. The next hearings will be held in the second week in December in Wagga. I am sorry that Mrs Hull is not here today. She was trying to get here, but she has promised me that there definitely will be no fogs in Wagga in December.

Resolved (on motion by **Mr Somlyay**, seconded by **Ms Burke**):

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

Committee adjourned at 1.26 p.m.