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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND
PUBLIC ADMINISTRATION

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HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION
Friday, 6 December 2002

Members: Mr Hawker (*Chair*), Mr Albanese, Ms Burke, Ms Gambaro, Mr Griffin, Mr King, Mr Latham, Mr Nairn, Mr Somlyay and Dr Southcott

Members in attendance: Ms Burke, Ms Gambaro, Mr Griffin, Mr Hawker, Mr King, Mr Nairn, Mr Somlyay

Terms of reference:

Review of the Reserve Bank of Australia's annual report 2001-02

WITNESSES

| | |
|--|----------|
| BATTELLINO, Mr Richard, Assistant Governor, Financial Markets, Reserve Bank of Australia..... | 2 |
| DEBELLE, Dr Guy Lawrence Geoffrey, Head, Economic Analysis Department, Reserve Bank of Australia..... | 2 |
| LAKER, Dr John Francis, Assistant Governor, Financial System, Reserve Bank of Australia..... | 2 |
| MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia..... | 2 |

Committee met at 9.33 a.m.

CHAIR—I declare open this hearing of the House of Representatives Economics, Finance and Public Administration Committee. I welcome representatives of the Reserve Bank, members of the public and the media, local residents and students from Warrnambool and the region. I particularly welcome the mayor, Councillor James Nicol, and state colleagues the Hon. Denis Napthine and the Hon. John Vogels.

This hearing is part of an established practice whereby the Governor of the Reserve Bank and his officers appear before the committee on a six-monthly basis. The hearing is part of the committee's review of the Reserve Bank's annual report for the year 2001-02. While the hearings are often held in cities, the committee has decided in recent years to hold some hearings in regional Australia. This gives recognition to rural areas and is also an important means of ensuring that the proceedings of the Australian parliament are seen and experienced by people who live outside Canberra, Sydney and Melbourne. It also emphasises the current difficulties being faced by many parts of regional Australia with the extensive drought. I will exclude the local area on that. It is also about the importance of taking into consideration some of the regional issues when we ask the governor and his board to think about the economic settings.

Later today, the committee will hold another public hearing as part of its current inquiry into local government. In many respects, the success of this inquiry—that is, the local government one—is linked to hearing evidence from councils and people all around Australia. At this morning's hearing, we will hear from the Governor of the Reserve Bank on a range of issues. These include monetary policy and, in particular, interest rates; the impact of the world economy on Australia; the housing market; progress in credit card reform; the fees charged by commercial banks; the impact of the drought on the economy; and measures taken by the Reserve Bank and other financial institutions in the light of terrorism.

Since the last meeting, Mr Macfarlane, I think *Euromoney* have named you banker of the year. On behalf of the committee, I congratulate you and your staff on what is an outstanding award and certainly a recognition of the great job that you do for Australia. Also, last night, quite significantly, the European Central Bank reduced interest rates by a significant half a per cent to 2.75 per cent. No doubt, you will want to comment on that. Again, I would like to, on behalf of the committee, welcome you and senior officials of the Reserve Bank to this hearing.

It is very significant that we are holding this in the Matilda Room. You might wonder why it is called that. This racecourse is quite historical in many ways. Not only is it the home of the Grand Annual but also it is where the tune of 'Waltzing Matilda' was first heard. Christina McPherson back in 1894 heard a band playing a tune which she then took to Banjo Paterson. She hummed it to him and he set the tune to words. That is the origin of the very famous 'Waltzing Matilda', right here where we are sitting.

[9.37 a.m.]

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

DEBELLE, Dr Guy Lawrence Geoffrey, Head, Economic Analysis Department, Reserve Bank of Australia

LAKER, Dr John Francis, Assistant Governor, Financial System, Reserve Bank of Australia

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

CHAIR—I remind you that, although the committee does not require you to give evidence under oath, the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House or the Senate. Giving false or misleading evidence is a serious matter and may be regarded as contempt of parliament. Mr Macfarlane, would you like to make an opening statement before the committee proceeds to questions?

Mr Macfarlane—Yes, I will do that following my normal practice. I would like to endorse your opening remarks and say what a pleasure it is to be in Warrnambool for the second hearing to be conducted outside the Sydney-Melbourne-Canberra triangle. The first was in Wagga Wagga and I remember at the time suggesting that the second should be a little further away from Canberra. Warrnambool certainly passes that test. It is an important agricultural and tourist centre, so is a fitting venue for this meeting, although, in a time of drought throughout the country, we seem to have found the one part of the country which does not seem to exhibit any of the characteristics of drought. I would also like to thank the Mayor of Warrnambool, Councillor James Nichol, for his hospitality in hosting a civic reception for the committee and the members of the bank appearing before it.

I might mention that we have a slightly different change of personnel on this occasion. Mr Stevens, the Deputy Governor, is in New Zealand representing Australia at a meeting of Southern Pacific central bank governors. Dr Edey, who was here last time, is unfortunately detained fighting bushfires on the outskirts of Sydney which are threatening his home. He will be ably represented by Dr Debelle.

I would like to start the substance of this statement by observing that, in the six months between this hearing and the previous one in May, quite a lot has changed. This has had an important influence on our judgment about what we needed to do with monetary policy. This change has happened relatively steadily, with the result that the financial markets and the public more generally have had no trouble in adjusting to the changed outlook. Over the past six months we have assisted, where we have thought it necessary, by way of several speeches and articles on the subject. They have probably helped at the margins, although I think the public was not having much difficulty in recognising the changing outlook as it unfolded. That being so, it could be argued that there is nothing further for me to add on the subject. However, I am very aware of the fact that I gave some quite frank indications about the expected future direction of monetary policy at the previous hearing and that those indications have not been

followed through. So I would like to place on the record before this committee another account of the changing circumstances, even at the risk of being accused of going over old ground.

In May I said to this committee that, since the Australian economy was behaving normally and the world economy was getting back to normal, unless unforeseen developments intruded we should continue the process of getting real interest rates back up to normal, while all the time carefully examining incoming data from both here and abroad to ensure that developments were on track. We did continue the process of getting interest rates up towards normal in June, but we have not done anything more in that direction in the following six months. Why not? The answer has been obvious to nearly everyone: something did intrude, and the incoming data from abroad showed that developments were not remaining on track.

After a promising start to the year, the world economy began to weaken about midyear. Financial markets, particularly equity and bond markets, were the first to show this from about the beginning of the second quarter. By midyear there were also signs from a range of economic indicators in the United States and the Euro area that the recovery was likely to be a lot weaker than was formerly thought. These signs tended to become clearer as events progressed during the second half of the year.

A good way of summarising this large body of data is to look at three indicators of perceptions of economic conditions: business confidence, consumer confidence and the consensus forecast of GDP growth. In the hard copy of my remarks, you will see a couple of graphs which show very clearly the change in perception through the year in the United States and the Euro area. We saw good improvement in the first half of the year, followed by a clear deterioration in the second half. Taking the last two years together, we had a weakening through the 2001 calendar year—in fact, last year was a recession year for most of the G7 countries—and saw an apparent strong recovery in the first half of this year, followed by a relapse in the second half of this year. The relapse does not mean that the world economy is returning to recession, but it does indicate that the recovery is going to be weaker than was thought likely in midyear.

This gradual change in outlook in the second half of the year obviously had implications for monetary policy around the world. In the first half of the year, those countries with strong fundamentals—such as Australia, Canada, New Zealand, Sweden and, to a lesser extent, the UK—had started the process of getting their interest rates back up to normal. This process was occurring when we met in May and, as I said at the time, we thought the process would be continuing. In the event, it did not continue for much longer, and in fact none of these countries has raised rates since July. One, Sweden, has cut them, as have the United States and, as the chairman informed us, the European Central Bank last night.

The caution shown by central banks such as ours derived in part from the downward revisions of world growth, which I have already shown, but also from our suspicion that the risks were on the downside. In other words, if an outcome very different from the consensus were to occur, it would be more likely to be weaker than stronger. Having said that, I recognise that, even though the second half of the year has been disappointing compared to the first half, equity and bond markets have become a little more confident over the last month or so. It is of course too soon to know whether this represents a change in direction or just another blip on the downward path.

Turning to the Australian economy, I will approach this by my usual practice of reviewing the forecasts I gave to the committee last time and presenting some new ones. Last time, I said we expected GDP growth through the current financial year—that is, 2002-03—to be between 3½ and four per cent. We are now forecasting around three per cent, so that forecast has been revised down. Obviously, the major factor behind the reduction has been the drought, but the weaker world economy has also had an effect at the margin. On the other hand, the fact that house building is now forecast to continue to expand for a longer period has pushed the forecast up somewhat.

For next year—that is, calendar year 2003—our forecast is for growth through the year of 3¾ per cent. The fact that it is higher than the current financial year rests, importantly, on the assumption that there will be a recovery from the drought in the second half of next year and that the world economic recovery will gradually pick up momentum through the year, as indicated by the consensus forecasts. As I said before, the strength in house building has continued for longer than was earlier thought, but it is not going to continue forever. We expect a downturn to occur in that sector in the course of next year, which will subtract from growth.

On the inflation front, I said last time that we were forecasting that the CPI would remain near the top of the target range in the current financial year, 2002-03, although we expected it to go down slightly for a time and then to come back up. Implicit in this forecast was that the rising phase would continue after mid-2003 and so, all things being equal, begin to exceed the target range by the second half of 2003. So far, the headline CPI is slightly above three per cent, but our estimate of underlying inflation is that it is running at about 2¾ per cent. We see no reason now to expect underlying inflation to rise any further and are forecasting that it will stay around this rate through to 2003 calendar year. So that is a slight downward revision to what we told you last time. The main reasons for this slight downward revision, compared with our forecast six months ago, are the lower forecasts for world and Australian growth. This will not show up smoothly, because the price effects resulting from the drought will have the effect of holding up the CPI in the next quarter or two and then reducing it slightly later in the forecast period. So, basically, the story there is that we have had slight downward revisions to both growth and inflation in the current financial year.

I now return to a subject that the committee spent a fair bit of time discussing in May—namely, residential property prices. As you know, we became particularly concerned about this issue when we noticed that virtually all of the increase in housing loan approvals in the past year was to investors, not to aspiring owner-occupiers. At the same time the building approvals data, not the loan approvals data, showed that monthly approvals to build multi-unit developments—that is, apartments—had sped up to an exceptionally fast pace, while approvals to build houses were chugging along quite steadily. These developments suggested to us that a disproportionate amount of the upward pressure on residential property prices was coming from investors. One response to this would have been to sit back and do and say nothing on the grounds that the market would sort out the problem. We accept that it no doubt would, but it could take a lot of time. In the meantime, the excesses would get worse, and the eventual resolution of the issue could cause a lot of financial distress.

The problem is that the market works, but with long lags during which people are encouraged to take decisions based on little more than an optimistic extrapolation of what happened in the past. Developers will continue to put up new apartment blocks while there are investors willing to precommit to buy. These are the investors who turn up at seminars where they are told by the

developers how they can become very rich if they highly gear themselves and buy an apartment. When these investors purchase apartments off the plan—and, as I said, it is almost exclusively investors to whom the marketing is directed—they are making a financial commitment the wisdom of which will not become apparent for 18 months or so. It is only when they take possession of the apartment that they discover whether they can find a tenant willing to pay high enough rent to justify the financial calculation that underlay the original purchase. Of course, any individual investor can hope to get around the problem by selling to another investor, but they in turn will depend on finding a renter. Investors as a group are dependent on finding enough tenants willing to pay sufficiently high rents when the time comes, which may be 18 months away or more.

These investment calculations, or forecasts—and that is what they are: they are really forecasts—are difficult, and we fear that many investors are just assuming that things will work out, which is a very dangerous thing to do if you are making a highly leveraged investment. Certainly recent trends would warn against such an assumption. From the best figures available, it is clear that rents are falling and that vacancy rates are rising. As the pipeline of partly built buildings is completed, there will be many more new apartments coming onto the market in the next two years than in other recent years.

Our purpose in what we have been saying is to try to get the market to work a little better and so avoid the overshooting that so often characterises parts of the property market. We all remember the excesses that occurred in commercial property in the 1980s and the large falls in prices that followed them—falls of over 50 per cent. Investors should remember that, even when they are buying a residential unit, they are making a commercial property decision—that is, they are borrowing for an investment which will be rented to a tenant with the purpose of making a profit. It is a very different decision from that made by owner-occupiers.

There are now some preliminary indications that market forces are starting to work at last. I have already referred to falling rents and rising vacancy rates, but there is also recent evidence of a flattening out or, in some cases, falls in apartment prices and marked falls in auction clearance rates in Sydney and Melbourne. There have also been reports of some of the more ambitious projects planned for Brisbane and Melbourne being withdrawn, which makes it all the more surprising that in October there was such a large increase in approvals to build multi-unit buildings. However, on balance these developments, if fully understood by investors, should make them very cautious and so limit the extent of oversupply in coming years.

The other big event that has occurred in our area since we met in May is that in August we brought down the final report on the reform of credit card schemes in Australia. We welcome your endorsement of the reforms, Mr Chairman, as being ‘an important win for Australian consumers’. As stated in our document, our intention is to put these reforms into effect in stages over the next year. Although the reforms are being challenged in court by the two main international credit card systems, I do not think that this court action will necessarily prevent me from answering questions that are put to me. I do not think I need to say any more at present. We will have plenty of time to discuss any of the subjects I have covered, plus any others that committee members may wish to raise.

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

That the statement by the Governor of the Reserve Bank be received as evidence and authorised for publication.

CHAIR—Thank you very much, Mr Macfarlane. I noticed that you devoted a significant part of the opening address to the question of apartment housing. You made a very frank assessment of where you see the price of it going, and we will come back to that in the course of questioning. I would like to start by asking you a question on monetary policy. I note in your statements you have moderated your inflation forecast and have tried to anticipate the pluses and minuses of the impact of the drought. Many commentators have been suggesting that nothing will happen with interest rates until the middle of next year. In fact, some have been fairly candid in their comments about what the role of the Governor of the Reserve Bank might be for the next few months. I note your comments about getting back to normal rates and I am wondering whether you could give some indication of—as no doubt it is still your desire to do that—what sort of time frame you see being brought into play, when it might start and over what period it might move.

Mr Macfarlane—That is difficult to do. As I said, I tried to do that last time. I think everyone thought that I was franker than I had ever been, and then circumstances changed within basically a month of what I had said. At the time when I made those comments on the basis of the sorts of forecasts that we had in our minds, we would have thought that we would have already made several increases that would have brought us back very close to normal. As it turns out, we made only one. We made one within a week of the meeting and we have not made any in the following six months. At the moment, we are not sitting on the edge of our seat waiting for the first opportunity to do that, because our assessment of particularly the world economy is that it is unlikely that that would be required in any short time horizon. In fact, I was trying to get across that at the moment we do not have any sort of agenda that we can disclose. It was very rare last time that we were in a position where we had something to disclose—most of the time you do not. Most of the time you are sitting there, you are looking at the information as it comes in, you have some sort of forecast and the risks are equally balanced on either side of that forecast, which means you basically have your interest rates where you think they should be, given the way the future looks to be developing.

At the moment, we are not giving speeches talking about any imminent need to get back to normal. I hope we do get to the point where we start doing that again, because that will be good news. That will mean that the Australian economy is functioning as normal and the world economy is functioning as normal. I would like the world to evolve in such a way that we could then revive that manner of speaking and that course of action. That would be very good news. At the moment, we are not doing it, because we have received what is essentially disappointing news—that the world economy is a weaker place than we thought and, largely because of that and the drought, the Australian economy is a bit weaker than we thought.

CHAIR—I will put it another way. I think you refer in your statement on monetary policy to your hope that the Bureau of Meteorology can get its expectations fulfilled. If we do see a breaking of the drought in about April or May next year, to what extent would you feel that any movements in the US rates would give you confidence to move that way? I think US rates are currently at 1.25 per cent, which is the lowest in over 40 years, compared to ours at 4.75 per cent. Given those two factors, if the US started to move their rates up, at what stage would you feel confident to change ours?

Mr Macfarlane—Firstly, the major determinant of monetary policy is not the drought; the major determinant is the world economy and the future of the world economy. Secondly, the movements in US interest rates are interesting to us not because of any arithmetic relationship

between US interest rates and Australian interest rates. For example, when the Fed reduced the Fed funds rate about a fortnight ago the crucial thing for us was not that there was some widening in the gap between our interest rates and US interest rates; the crucial thing for us was that the Fed's action indicated that they had now accepted that the US economy was a lot weaker than they had formerly thought. The important piece of information that came through to us from that action was the confirmation that they felt the outlook for the US economy was weaker than had formerly been thought.

Similarly, the crucial piece of information coming from the ECB is not that there was a 50 point change or a 25 percentage point change but that they were perhaps somewhat belatedly recognising that the recovery they had been expecting was not occurring, Europe was just limping along and, limping like that, they had a set of interest rates which were probably higher than necessary; and they moved them down. So it is what it tells us about the world economy that really matters when those major central banks move their interest rates. It does not worry us in any mechanical sense whether our interest rates are two per cent, three per cent or 3½ per cent higher. That particular number is not of great importance to us.

CHAIR—I am sure you have had a fairly close look at some of the indicators from the United States, and they are obviously very significant. Could you give us your assessment of what is happening in the United States and speculate on what might happen if certain decisions are taken on the Middle East?

Mr Macfarlane—On the US, we have tended to be slightly more pessimistic than the official forecasts because we have tended to believe that some of the excesses that occurred in the US corporate sector would take longer to work out than US economists thought. So we have always tended to be a little on the weaker side of US official forecasts, and that is why we were influenced when we saw the US reduce their interest rates. It seemed to us as though they were saying, 'We also think that things are a bit weaker than we formerly thought.' The GDP numbers for the US look okay. The most recent one that came out was three per cent for the September quarter over the June quarter, but that is a very dated figure which is centred on the month of July. The more recent data coming out of the US—the monthly data, for example—show that industrial production has fallen in the last three months. It had started to rise through the first half of the year; then it fell again. The figures for the last two months showed declines in employment. So we felt that the weight of information on the US economy coming in over the last three or four months was disappointing and showed that the US economy was weaker than we had formerly thought. As to the vexed question of what will happen if there is a war, I do not know very much at all. I do not think anyone does unless they are a military expert and able to forecast when the war will start and how long it will last. Obviously I do not even know whether there is going to be one.

CHAIR—Neither do we.

Mr Macfarlane—If there is one, I do not know whether it is going to be a quick one, like the Gulf War, or a long one. If it is a quick one, the effects will not be very profound; if it is a long one, they could be. I also think that a lot of people do not even know the direction of the effects. We know that one of the effects will be to drive up the oil price in the short run, and that will be contractionary for the rest of the world. But historically, if you look over the last century, most wars have ended up being expansionary for economic activity. That was certainly true in the Second World War and the Vietnam War. The situation is so complex that it is not something

you can factor into your assessments of how you should be conducting monetary policy now, in December 2002.

Ms BURKE—Do you do modelling on it, though? Does anyone sit down and think, ‘X effect is going to happen to oil prices’, and all the rest of it? Are there ways of modelling or calculating it? Most of your life is about prediction. This is a factor that may be predictable, so do we do that or don’t we?

Mr Macfarlane—We do not do it. We do not do it because you would have to have so many permutations and combinations of outcomes. You could perhaps follow through in a model things like ‘If this happened, that would be the result; if that happened, another result would occur—if it’s a short war, this would happen; if it is a long war, this would happen; if there is no war, this would happen’, but you would not know which of those three scenarios was the one that was going to occur.

Ms BURKE—You have told us today that you have revised your forecast for 2003 to 3¾ per cent. The government has recently released its Mid Year Economic and Fiscal Outlook and has downgraded the government’s economic growth forecast from 3¾ to three per cent. Again, you are slightly out of tune and out of line. Is there any big difference?

Mr Macfarlane—We both have three per cent for the current financial year.

Ms BURKE—You both have three per cent. Sorry—you are talking about the calendar year 2003.

Mr Macfarlane—In a situation like this where we are meeting in December, we tend to say, ‘What’s the most interesting relevant period? It is next year—the year that is about to start,’ so we use the calendar year. The government rarely does that, because the government has to work within the framework of its budget cycle and the budget cycle is always financial year to financial year.

Ms BURKE—Going over old ground a bit, what are the factors we can or cannot predict that might drag down growth over 2002-03?

Mr Macfarlane—We have three quarters of 2002-03 to go. We have 0.9 per cent under our belt and we are only saying that we are going to get three per cent, so we have got 2.1 per cent to get over the next three quarters. In a sense, we are assuming that the next three quarters will have, on average, lower quarterly growth rates than the one we already have under our belt. The drought will be part of that. We think that the drought has already affected the September quarter, will affect the December quarter and will affect the March quarter. If the drought did not break, that would clearly be another downward factor. It would probably give you a slightly lower figure for the year. If the world economy turns out to be a lot weaker, that will be important and that could lower it a little bit.

The cycle in housing and house building which I referred to might have sounded a little confusing the way I said it. We thought it would have turned down a quarter or two ago, but it has not. The sum of all the houses and the units that are being built is still continuing to grow at quite a good rate. It has continued a lot longer than we thought, but we still think it is going to run out of steam. We are building more houses and units than we need. We have not got enough

people to put in them so at some point that is going to turn down. We are assuming that it is going to turn down and subtract from growth, probably throughout the next calendar year, but it is a cycle that obviously you cannot pick exactly. If we could have picked it exactly, we would have picked it exactly, but our forecast had a premature downturn so that can obviously affect things.

We feel pretty confident about the two big items that determine an economic forecast. We feel reasonably confident about consumption and we feel very confident about business fixed investment. That was something that was a bit sluggish even during the good period of the second half of the nineties but it is really coming back. All the surveys we get from businesses say that that is on track and that that will help to underpin our economy. And that is something that gives you a lot of reassurance, because it was missing in the economies that have turned down—the really weak ones, particularly the US. One of the driving forces turning the US economy down is big reductions in capital investment expenditure. They built too much in the late nineties, had overcapacity and there is a string of negatives going back about seven quarters. Similarly in Europe they have had negatives on business fixed investment. That is another example of where we are out of sync with the rest of the world in a very helpful way.

Ms BURKE—Do you have confidence in consumer spending, given that the current retail figures are not showing a huge spike for Christmas spending?

Mr Macfarlane—No, we do not want a great spike; we like things to just chug along. We had a negative one on the last figure that came out, but those monthly ones bounce around quite a bit. When you look at people's income, at employment and at surveys of consumer confidence, I think we are in pretty good shape.

Ms BURKE—On the US future outlook, because obviously that has a huge bearing upon us, how do you think they are going to track over the next financial or calendar year? What impact will that have on us—hypothetically, if the Feds turned around and raised their interest rates?

Mr Macfarlane—On the first bit as to how they are going to go, we think the economy is going to continue to recover but it will be a weak recovery. One of the fascinating things about the US business cycle and the US recession is this: how come they had such a huge asset price boom and such a big asset price bust and they only had a shallow recession? There are two explanations—one of which you hear a lot about and one of which you do not hear much about. The first one that you hear a lot about is the very quick and major loosening of monetary policy—getting those interest rates down a huge amount, and quickly. The other thing that you do not hear much about, which is probably equally as important, if not more important, is that the US had a massive fiscal expansion. The US moved from surplus to deficit to the tune of three per cent of GDP in one year.

Now that is a massive swing around. If they had not done that, their GDP would be three per cent less. You would not be talking about a mild recession; you would be talking about quite a deep recession. Whether that was due to good management or good luck is for people to argue about, but certainly the timing was ideal—to have that fiscal turnaround at the same time as a very quick monetary expansion. I mention all this because in a sense they have fired off nearly all of their bullets—and they fired them early, which was the right time to do it. They took the bottom off the recession, but that probably means, all things being equal, that the recovery that

follows it is not going to be very steep. In the past it was often very steep. We are assuming quite modest growth in the US next year, but growth nevertheless.

You also asked what would happen to us if the US were to start putting up interest rates. The answer is that that would probably be pretty good news, because the US will not start putting up interest rates until they are confident that their recovery is going much better than they currently think it is. When we start seeing interest rates go up in the US and in Europe, that will be a very good sign; it will mean that we have got past the recessionary phase.

Mr KING—I want to ask you about interest rates. The US rates are 1.25; Europe is now 2.75 and Australia is 4.75. You talk about a ‘normal’ interest rate focus for the Australian economy and I am a bit concerned that you think it ought to be trending upwards from 4.75, when I do not know why it should not be trending downwards.

Mr Macfarlane—There is in some quarters a feeling that the only good interest rate is a low interest rate and that, somehow or other, very low interest rates are a sign of a healthy economy. It is actually exactly the other way round; it could not be more different. The lowest interest rates in the world are in Japan, which is in the grip of deflation and has had very little growth for the last decade. The second lowest interest rates of the major countries are in the US. The US is a country that has just been through a recession, and they are worrying about whether they are getting out of it and getting out of it fast enough to be sustainable. The euro rates are a bit higher again, and again that is an economy that is hardly growing at all. It constantly disappoints the policy makers in those countries.

When you get to the economies that are doing well and are growing, and have inflation of two or three per cent or somewhere around that sort of range, you will find that these are the economies that have interest rates up near where ours are. The UK is four, we are $4\frac{3}{4}$ and New Zealand is $5\frac{1}{2}$. There is one outlier which does not fit into my pattern, and that is Canada. They are terrified, because they have returned to growth but they still have interest rates which are much lower than they want. They have the serious problem of getting them back to where they think they ought to be without frightening the horses. Essentially, if you have an economy which is growing at $3\frac{3}{4}$ or four per cent and you have inflation which is growing somewhere between $2\frac{1}{2}$ and three per cent, the last thing that you would want is US, Japanese or European interest rates; they would be a recipe for disaster.

Mr KING—What do you say is the normal interest rate profile in the perfect world that you mentioned a little while ago?

Mr Macfarlane—At the last committee meeting, which you were not at—this is your first meeting—we had a bit of discussion over that and people dragged those figures out of me. I think at the time I suggested a real interest rate of about three to $3\frac{1}{2}$ —that is real—and then you add the inflation on top of that. If the economy was just performing at normal—in other words, they had that nice growth and that nice low inflation—the normal might be somewhere between $5\frac{1}{2}$ and six. Obviously, if you have very high inflation, it is going to be a lot higher than that. If you have deflation, as Japan has, it is going to be a lot lower than that. In fact, it is going to be zero in the case of Japan. But if you are normal, that is somewhere around where you would expect it to be.

Mr KING—Can you explain how the favourable terms of trade have compensated for the worsening current account deficit situation we have?

Mr Macfarlane—What we would have said is that favourable terms of trade have compensated for a worsening volume performance. In other words, the volume of our imports has grown a lot faster over the last year than the volume of our exports. The volume of our exports, of course, has been held down by weak demand in our export markets and, more recently, by the drought. If you look at the volume—the quantity—of exports and you look at the quantity of imports, then, if the prices had not varied, you would expect to see a current account deficit of a certain size. But what has been happening, which has been beneficial to us, is that the price of our imports is actually falling and the price of our exports is stable or slightly rising. This is unusual for us. Historically, during an international recession or slowdown, we used to have exactly the opposite effect: the price of our exports would fall and the price of our imports would stay where they were. That would actually make the volume situation even worse, whereas now the price effects are actually counteracting the volume effects—to some extent, not completely. We are gaining from the fact that, for the price that we buy our imports from the rest of the world at, we are getting better prices for our imports and we are not suffering on our export prices.

Mr KING—It seems as though, just comparing the US and Australian economies, our unemployment rates are somewhat similar. Is that right?

Mr Macfarlane—Yes, they are.

Mr KING—And the current account deficit profile is not dissimilar. Do you agree?

Mr Macfarlane—I do not have the latest numbers, but not that long ago the US had a larger current account deficit as a proportion of GDP than we have. What is the latest on that?

Dr DeBelle —About the same.

Mr KING—If that is the case, I am still having a little difficulty in understanding why their interest rate profile is 1.25 per cent and ours is 4.75 per cent. Can you explain the difference?

Mr Macfarlane—Interest rates have nothing to do with the current account deficit; that is the simple explanation.

Mr KING—What about the unemployment rate?

Mr Macfarlane—You set interest rates to try and achieve sustainable economic growth. We have set interest rates which have achieved sustainable economic growth. We have had 11 years of expansion at an average growth rate of 3.8 per cent and we are still growing at virtually that. We have interest rates that are achieving what we want to get, which is good growth and low inflation. The US have interest rates which, it is true, are lower than ours, but they are not achieving good sustainable economic growth. They are the ones who have the problem, not us. It is entirely reasonable that they would put those interest rates down, and in the fullness of time, when they have worked their way through, plus some fiscal expansion, they will return to sustainable growth. When they do that and the economy starts growing again at rates perhaps

similar to ours, they will move their interest rates back up again to rates similar to ours. They are the aberration, not us.

CHAIR—Unless there are any more questions on monetary policy—

Mr SOMLYAY—Following up from Mr King's question, I would like to raise the issue of international tourism post September 11. Is there any indication in the data that the dramatic fall in the number of visitors is affecting our export income and therefore affecting the economy, or is it being offset by domestic tourism increases?

Mr Macfarlane—I could have a go at that, but I suspect Dr DeBelle might be able to handle that one. He is a little bit closer to the numbers than I am.

Dr DeBelle—The international tourist numbers are basically the same as they were just after September 11, whereas in normal times you would have expected those to have grown at a reasonable pace. We have not had that growth in the international tourist market, but, as you rightly pointed out, the domestic market has offset that to some extent. We are not really in a position to say whether it has offset that completely, but it has certainly provided some offset. Yes, the international market is still at a level below where you would normally expect it to be, but yes, we have had some reasonable pick-up in Australians basically holidaying at home, driving to places like this.

Mr SOMLYAY—I was hoping you would say that.

Ms GAMBARO—I just want to talk about the drought again. In your recent statement on monetary policy, you said that the drought was expected to subtract 0.5 per cent of GDP. Others out there are predicting one per cent. Do you think you are being a bit optimistic? Do you know something that the rest of the economists out there do not know? If so, could that be rain, as the chairman predicted earlier? Why are you more optimistic than others are?

Mr Macfarlane—Actually, we are not more optimistic than others. I cannot remember where that 0.5 per cent came from. It might have been referring to some specific period. But overall we do accept that it will take a percentage point off GDP.

Ms GAMBARO—So you are agreeing with the rest of them.

Mr Macfarlane—Yes. Most of our assessment of the drought is not something that we do independently. We have other arms of government which are much better resourced to evaluate the outlook for various agricultural products. ABARE in Canberra has a huge staff, and they have people who are experts just on barley, wheat, rice, cotton and all the rest. With our limited resources, we do not attempt to put up a forecast to dispute what they are saying. They are constantly updating their estimates. By and large, we basically take that on board. We do not have a different view about the drought from the agricultural experts.

Ms GAMBARO—Just on farm debt and the ability to service that farm debt, what are your indications at the moment on that? How is that looking?

Mr Macfarlane—Farm debt is not actually rocketing up. I suspect one of the subjects we will get onto, if this is like previous meetings, is debt in general. The big stories about debt are

not about farm debt. Farmers have been quite responsible. In the good seasons, they have paid down their debt; they have put money away in farm management deposits. I think that is one of the success stories of financial management.

Ms GAMBARO—And they have been working pretty well?

Mr Macfarlane—Yes, I think it is working very well. I think it is one of the success stories of financial management over the last five years—the way the farm sector has managed to reduce its debt and build up these deposits.

Ms GAMBARO—I would like to ask another question on apartments. In your statement today, you mentioned that there had been withdrawal of apartment projects for Brisbane and Melbourne. I know we tend to ask you this question, and it has been the subject of other hearings. In your opinion, is there a timelag between what is happening in Sydney and Melbourne with apartment projects and what is happening elsewhere? Alex Somlyay and I are from Queensland, and we tend to see a timelag in building developments as well. Do you have any clearer indication of what is happening there in terms of them being withdrawn or do you see that as just a short-term thing?

Mr Macfarlane—Mr Chairman, should I answer that now? Do you have other things to do before we get to that?

CHAIR—We might come to that later. I just want to ask one quick question on foreign reserves. I note from the monetary policy statement that foreign reserves have gone from \$7 billion up to a bit over \$11 billion, maybe more. That was in October. I am just wondering whether you would like to expand on why you are buying these reserves, how much further you think you might go and what impact you feel that could be having on the exchange rate.

Mr Macfarlane—The reason we are buying them is reasonably simple. We actually used a lot of them up by selling them to buy the Australian dollar during the very troubled period of 2000 and the first quarter of 2001. If you remember, the Australian dollar went down to 47c. We thought that was an overshoot; we thought that was too low. We used up a lot of our reserves to buy the Australian dollar. As a result, they got to a very low level. That is not a satisfactory situation in the long run. Once again, we would like to return them to normal. That is what we have been doing—just quietly, not intending to have any big impact, not making big announcement effects, not taking a view about the exchange rate and saying we want it to be here or we want it to be there. We are simply quietly reaccumulating reserves to get them back to a more normal level in case we need to use them again.

You ask what effect that has on the exchange rate. At the margin, it probably holds it down a little bit, but our guess is that the effects are very, very small. The history of foreign exchange intervention shows that, if you want to have an effect on the exchange rate, the thing that matters is how you affect people's expectations. If you come in and you make a big statement, do a lot in a hurry and it knocks the currency, that can have a big impact on people's expectations and therefore you affect the exchange rate. If you have the opposite aim—you do not particularly want to affect the exchange rate but you simply want to restore your level of reserves—you just buy a bit here and a bit there. We are always in the market, of course, buying a bit here and a bit there for the government anyway. People do not see our behaviour as being any different from what it normally is. It is just that we are doing a little bit more than we

normally do. At the margin, I suppose it has to have an effect, but we would imagine that it would be a very, very small effect.

CHAIR—As a rough indication, what do you consider normal? That wonderful word comes up again.

Mr Macfarlane—It keeps coming up again.

Ms BURKE—You said last time that you are more comfortable when things are returning to normal.

Mr Macfarlane—We have discussed this amongst ourselves. I do not know that we have ever really come up with anything where we felt so confident that we wanted to make it a benchmark that people can judge us by, but we would think that one definition of normality would be to have half of the assets of the Reserve Bank in foreign assets and the other half in domestic assets. We are a long way short of that at the moment.

CHAIR—If there are no more questions on monetary policy, I welcome Mr Nairn and Mr Griffin. I am sorry about the delay, whatever it was. I am sure you are too.

Mr NAIRN—It wasn't the drought.

Mr GRIFFIN—It wasn't us, put it that way.

CHAIR—I am not blaming you. We might just move on now. In your opening statement, Mr Macfarlane, you devote about a quarter of it to talking about apartment prices. We have already discussed it a bit. One of the things I was wondering whether you might like to expand on is this. You are suggesting that there could be some downturn in apartment prices. One could assume that quite a few people buying apartments are doing it for investment, not for living. If that becomes a problem for them—and I believe that many have probably used their own house as collateral—what effect might that have on housing prices generally?

Mr Macfarlane—Can I start to answer that by making an observation about the difference between this particular period of heightened investment in property and earlier periods. It is not new for a lot of middle income households and upper income households in Australia to want to buy an investment apartment. That has been around for a long time. People have always thought that that was a tax effective investment.

But two things have changed. One is this. In the 1970s and 1980s, even though people were trying to do that, it was very hard for them to get the finance, to get credit. Banks did not want to lend for that. They used to charge a penalty interest rate. You had to actually have the deposit up front in cash. What has happened during the 1990s is that a lot of those constraints have disappeared. Not only do you not get charged a penalty interest rate; banks are actually advertising for you to come and borrow from them for this purpose. You do not actually have to have the deposit up front. That was another thing that limited the amount that could be done. You can use the equity in your existing house as your deposit. And there are new financial instruments such as deposit bonds that have been created that just make it so easy for people to do it. People can actually make these investments on almost 100 per cent gearing. That is what makes it a lot different from the earlier property booms. Many more people can get into it now.

It is so accessible that people on very modest incomes are being persuaded by the big seminars that are run by the property development companies that the way for them to get rich is by buying these apartments. That is the first big change that has occurred between this and previous property cycles.

The second big change—and I am getting around to answering the chairman's question—is that in previous cycles most of the risk fell on the property developer. The property developer built the thing. It always takes time to build. They built it when everyone was optimistic and then it came on stream 18 months later. If the circumstances had changed—if it was difficult to find people to buy the apartments 18 months later or they would only buy them at very low prices—the property developer got into trouble. Many property developers went broke. We had a history of property developers going broke. In every cycle, a whole lot of property developers went broke. The thing about this cycle is that nearly all the projects are presold. What has happened is that the property developers have shifted the risk from them onto the investor. If, in 18 months time, when the building is completed, the market has turned and no-one wants to buy investment units—or, if they do, they only want to buy them at extremely low prices—the person who bears the financial risk is the investor. They committed 18 months ago; they have paid their 10 per cent; they have taken possession. They are the ones who bear the risk. The property developer has been successful in shifting the risk onto the investor. The bank, as well, has shifted the risk in the same way. The bank is no longer as exposed to the property developer as it was, because the property developer has shifted a lot of their risk onto the investor.

Some people would say that this is a very good development, because it means that we have not concentration of risk but diversification of risk. The problem is that all the individual units that it has been diversified to—not all of them, but many of those individual units—are not in a position to take on that sort of risk. It could be very tough for some of those people if they discover they have an apartment, they cannot find a tenant, they want to sell it and the prices that people in a secondary market will buy at are much lower than the prices at which the developer sold to them 18 months ago. All the risk—not all of it, but a very high proportion of the risk—is ending up with the investor. I do not know how the investor handles that. I would imagine that, if the investor is quite wealthy and has their own home with a lot of equity in their own home, they will just tighten their belt, put up with it and discover that their annual loss is much bigger than they thought it was. In extremis, if something happens—they lose their job, there is a divorce or something and they have to sell—they could conceivably incur or realise quite a big loss.

CHAIR—What I was coming to is whether there is a likelihood that this will flow back onto housing as opposed to apartments.

Mr Macfarlane—At the margin, there is substitution. Not all investors buy apartments. Some investors buy houses. Similarly, a lot of owner-occupiers do not buy houses either; they buy apartments. So there is a flow of influence going both ways. That is why I said at the beginning that we think an important source of the upward pressure on house prices across the country is coming from the investors. It does spread to owner-occupiers and it does spread to houses rather than apartments. But the bit that is clearly overheated—the bit that very strange things are happening in—is the investment sector. That is the bit that, compared to normal behaviour, looks very strange. It looks very overheated and it looks very risky. But it is not confined to that sector; it does spread to other parts.

Ms BURKE—Given those answers, do you also share APRA's concern about banks loosening their risk management practices? There was an APRA press release in October of this year which stated:

Mr Thompson said that associated with this, APRA is observing some loosening in scorecard underwriting standards for individual borrowers and, in isolated cases, loans that do not meet the 50 per cent concessional capital treatment being structured to claim this concession.

There has been some loosening of risk management practices, particularly, as you note, in the investment sector. Do you share those concerns about the banks' lending practices?

Mr Macfarlane—I think that APRA are right to be doing what they are doing. I do not know the individual cases, but I know they are concerned. I am concerned that it is so easy now for someone to make this decision. You could almost make it impulsively. You go along and you are told that you are going to become very rich if you do this. In the old days, it was difficult for you to do anything about that. First of all, you had to have a 10 per cent deposit from somewhere, and very few people had a 10 per cent deposit lying around. If you did have the deposit, you then had to find someone who would lend you the money. As I said, most financial institutions were very reluctant to do it and, if they did it, they did it on very demanding terms with a higher interest rate and a low loan to valuation ratio. If people had the idea that they wanted to do it, in most cases they simply could not do it. Now you can go along and, if you are persuaded to buy and you have a house with a bit of equity in it, you just go along to an insurance company and buy a deposit bond for hundreds of dollars—not thousands of dollars. The insurance company will then guarantee to the developer that the deposit will be paid upon completion, and you just sit back and wait for 18 months. The cost to you is negligible. Then suddenly, in 18 months when you take possession, you have to do a lot of things. You have to go and get the full finance. That may be the point when you start having regrets about what you did 18 months ago which was so easy to do at that time.

Ms BURKE—Do you also see some concerns with the first home buyers grant that people used as their deposit? Are you concerned about people thinking that they have been given this nice whack of money from the government so they will go and use it and buy something with that nice lump sum without showing that they have been able to save or repay?

Mr Macfarlane—I think that is a different subject. For a start, it has to be for owner occupation; you cannot use it for investment. That is a big difference. In most places, that sum of money has to be added to something else in order to get a deposit to go ahead. We would all have to say that that is a good thing if it enables people to get into owner occupation. It is true that in some parts of the country house prices are so low that \$7,000 is enough for a deposit. If banks lend on that basis, they are certainly taking a risk. I cannot rule that out as necessarily being a bad thing. It is quite possible that there are places that are slightly depressed where property prices are so low that that enables someone to get into their first house. The only way that these schemes—firstly the \$7,000 to compensate for the GST and then the other \$7,000 which was the additional grant—get into this picture is that they do what I think is a good thing in that they take some marginal renters and turn them into owner-occupiers. That is reducing the future stock of renters, although probably at the lower end. That makes you wonder why we are trying to expand the stock of rental accommodation at such a rapid rate if we know that the stock of renters is actually going down.

Mr KING—It has been suggested that you and the banks have toned down the heat in the property market and that it is cooling off a bit but I notice that in October dwelling approvals for apartments and town houses rose an incredible 68 per cent. That does not sound like a market under control to me.

Mr Macfarlane—That was an almost bizarre figure and I had some of the same feelings that you are obviously expressing. I felt that the market was doing some of the work, driving down rental yields and actually driving down rent in dollar terms in a lot of parts of Sydney, Melbourne and Brisbane. Vacancy rates were going up. The market was doing that. I think some of our comments have made investors a bit more cautious—

Mr KING—I think that has been good.

Mr Macfarlane—Yes, and one of the signs of that is that the auction clearance rates have come right down. But then on the supply side we suddenly hear that there is this massive increase in potential supply coming on stream in October.

Mr KING—Maybe it was approvals, not constructions.

Mr Macfarlane—They are a fair way down the path. They could easily be withdrawn. We know that huge one in Brisbane was withdrawn, even after they spent a fortune on marketing. They had John Laws on the radio telling everyone what a great apartment it was. Even at that point it was withdrawn. We know that there are at least three in Melbourne that have been withdrawn. I could give you the names if you asked. There are certainly a lot of people in the property industry who are conscious that there is almost certainly going to be oversupply, and they are withdrawing things. That is the other thing that made it so surprising that in October we suddenly got hit with this huge number of potential new apartments. I can only assume that a high proportion of that will not be built. If they are and if that sort of thing goes on, there is going to be a massive oversupply.

CHAIR—Anyone who is listening must have got the message by now.

Mr Macfarlane—Some of the information that property research firms are coming up with is quite disturbing. These people are not real estate agents; they are pure researchers and they provide information that they sell to the property industry. One set of figures I saw recently showed that in Melbourne, at the height of the boom, which was over the last five years, there have been 2,500 new apartments a year coming into inner city Melbourne broadly defined, including St Kilda Road and Docklands. But waiting in the wings to hit the market next year, the year after and the year after that are either partly built buildings or buildings that have got right through to the building construction approval stage, not just development approval. There are 7,000 a year of those. I just do not know how at this point you could start to try and absorb three times as many per year as you have had difficulty absorbing over the last five years.

Mr NAIRN—I understand that you have covered the drought but I was particularly interested in the Reserve Bank's take on what might be happening with respect to the draw-down of overdrafts by the farming sector and FMDs. If you have fully covered those in earlier answers, tell me and I will ultimately read the transcript.

Mr Macfarlane—I have but I will say it quickly. We think that farm debt is one of the success stories in that it has not gone up very much at all; in fact it was paid down during the good years and has hardly gone up since then. As well as that, the farm management deposits were built up also during the good years. I think this is one of the success stories of the Australian finance sector—how the rural sector has handled its debt, not just this year during the drought but in the lead-up to the drought.

Mr NAIRN—That is what I am finding in my particular electorate, but part of the reason that I am being told that the overdrafts are not being drawn down and FMDs are not being got at is that a lot of farmers are worried about increasing debt and are in fact reducing herd levels instead of tapping into an overdraft. The facility is there for them to do that, but there is a lot of caution about any further debt and they would rather reduce their stock levels.

Mr Macfarlane—This is really a farm management issue. I do not wish to lecture farmers on how to do it, but I could imagine that they would always have this difficult decision: do I keep producing at my current level and build up debt, or do I do a bit of reducing my production and a little bit of drawing more debt? It seems to me that it is a decision that individual farmers have to make and I think they have better facilities for making those decisions than they have had in the past. I would not want to be making that decision, because, amongst many other things, they have to be weather forecasters and so on.

CHAIR—We might move onto the question of the bond market. I know you have not said much recently, but in the past Mr Battellino did have some comments to make about what the loss of a bond market might be. Is the Reserve planning to make a submission to the review of the Commonwealth government securities that the Treasurer has announced?

Mr Macfarlane—No, we will not be making one because we have already been consulted on the one aspect that we believe is relevant to us. There are three scenarios. The first is that nothing happens: Telstra does not get fully privatised, in which case there is not any point in having the discussion. The second scenario is that it does and the proceeds are used to pay off debt. The third scenario is that, instead of paying off debt, some assets are acquired and the debt is still held. We have been asked whether we could continue to operate monetary policy as we do currently if either the second or third scenario came to pass. We have said, ‘Yes. Neither of those two would prevent us from operating monetary policy as we currently do.’ The obvious one that people thought might prevent us is if the debt was paid off and there were not any Commonwealth government securities. But we feel that there are enough other marketable securities or foreign exchange that we could use to do our open market operations; that is, to make sure that there was the right amount of cash in the money market to keep interest rates where we wanted them to be.

Ms GAMBARO—In relation to Commonwealth government securities, if, hypothetically, we had no government securities, would that affect the level of overseas investment in this country, or would it make it more volatile for investors to come in?

Mr Macfarlane—I think in the very short run it might mean that some overseas investors who have traditionally bought Commonwealth government securities might find it more difficult for them to take an exposure to Australian fixed interest securities because the Commonwealth government securities are the easiest ones to take an exposure to because there is no credit risk over time if the corporate debt market continues to grow at the rate it has been

and, in fact, the corporate debt market is bigger than the Commonwealth government debt market now. It never was for the previous 30 years but in recent years it has become bigger. In fact, is it bigger than both Commonwealth and state now?

Mr Battellino—It is about the same.

Mr Macfarlane—Yes, the same as the sum of the Commonwealth and state debt markets. In time, I think they would learn how to assess credit risk, and in those circumstances, if they wanted to take an exposure to Australian fixed interest securities, they would come back. It could easily be a transition problem because the thing that they know and love is no longer available to them and the alternatives are a little more complex to understand. My guess is that they would learn to understand them.

Ms GAMBARO—You are quite confident that you could operate in a situation where the bank would have other alternatives?

Mr Macfarlane—Yes, in the narrow subject of how we do our daily domestic market operations, we believe we could do that under any of the three scenarios.

Mr GRIFFIN—You are saying you can do it, but are there impacts for the way you do things and are they likely to have impacts in terms of the efficiency of what you do?

Mr Macfarlane—I do not think they will be very big but Mr Battellino is the expert. He was the one who gave the main advice to the government, so maybe he could tell the committee.

Mr Battellino—I do not believe there will be significant impacts on the bank's operations. At the margin, there would be some increase in credit risks that the bank undertakes, because currently we buy Commonwealth government securities. Obviously, since the Commonwealth government owns the bank, there is no credit risk in it for us, but anything else we buy will involve a normal credit risk. When you look around the world, the sorts of securities that other central banks buy are much more diverse than we have bought in the past. It is quite common for central banks around the world to buy a whole range of private sector securities. We could easily expand the range of things we buy and still be well within the norms by international practice.

Mr GRIFFIN—You mentioned international comparisons. Where else in the world is anyone contemplating not having a bond market?

Mr Battellino—Currently, there is no major country in the world that has not got a developed bond market. That reflects the fact that, through the 1970s and 1980s, most developed countries went through a prolonged period of large budget deficits and they all ended up having a bond market. There was a time when the Swiss economy had very little in the way of bonds on issue and they survived very well financially despite that. If you go back through time there are periods—

Mr GRIFFIN—Is the Treasurer considering a Scandinavian alternative? That is a frightening prospect.

Mr Battellino—I mentioned Switzerland, not Sweden.

Mr Macfarlane—As a historical aside, we went through the same discussions in 1989. I gave a paper in the United States canvassing the possibility of how you would conduct monetary policy if there were no government bonds. In the late 1980s, there were four years in a row of quite significant government surpluses. The stock of bonds on issue started to fall away quite sharply and we were going through the same discussion, namely about what we would do if we ran out of bonds. This is not the first time that we have confronted this. Of course, we know what happened last time; we had a recession, we had huge budget deficits and the stock of bonds went back up again. This is not the first time we have discussed it, and it is not the first time it has been discussed in other countries either. Two years ago the US was discussing exactly the same subject.

Mr GRIFFIN—Maybe it is something that should not be discussed.

Mr Macfarlane—Their surpluses did not last very long; they went back to budget deficits and a big supply of bonds came on stream.

Mr GRIFFIN—Could you comment on the issue of cost of funds?

Mr Battellino—Is this to the private sector borrowers?

Mr GRIFFIN—Yes.

Mr Battellino—This is a question that is being debated at the moment. I do not think there have been any conclusions drawn as to what the overall impact will be. Some people are saying that it is going to be very hard to price private sector securities if you do not have a Commonwealth bond market to price it off, but that still remains to be tested

Ms BURKE—Some are predicting that there will be a rise of 20 basis points or more on capital.

Mr Battellino—I think, at this stage, I would have to say that that is only speculation. I do not think that anybody could be precise as to what the impact would be on these sorts of issues.

Mr NAIRN—Just further on this point: to what degree are there foreign investors who invest exclusively in Commonwealth securities?

Mr Battellino—Overall, I think, somewhere between 30 and 40 per cent of existing Commonwealth securities are held by foreigners. Whether those holders are exclusively in Commonwealth securities is hard to tell, because what has increasingly happened as the corporate bond market has developed is that the foreigners are participating more and more in that. One of the reasons that the foreigners used to buy Commonwealth securities in Australia was that that was all there was to buy. If you go back 10 years, there was very little in the way of corporate debt to buy. Now, with the corporate debt market having developed so much, the foreigners are participating. If you go overseas, particularly in the US, the end investors are very comfortable with buying corporate debt. They have had a long history of dealing in corporate debt. For them to make a transition into corporate debt in Australia is not a big issue.

Mr NAIRN—So we do not really know the answer. Is there any way of finding out?

Mr Battellino—The corporate debt market is much more disaggregated and diverse. It is hard to precisely track the participation by foreigners. I think all indications are that it is increasing.

Ms BURKE—Given the current state of the world economy, don't you agree that best practice is to have a sound banking system supported by prudential regulations plus robust capital markets that are largely independent of banks? Isn't that the path that Singapore and Hong Kong have both pursued in the wake of the Asian financial systems? Isn't such a contemplation as the government is embarking upon against some of those better practices in banking?

Mr Macfarlane—If we are still talking about this issue of what to do with the proceeds of Telstra privatisation, I do not think that it will have any implication for the banking system. We do have a very sound banking system and we have a very well regulated banking system. It is clearly at world first best standard. The only issue is whether it would in any way harm our private capital market.

We concede we are going into uncharted waters. We concede that. There is no major country that has had a long history of a government bond market no longer having government bonds. We do not have a model to follow. We will be the first one to do it, but there are risks either way. There is a risk in doing that and there is also a risk in going the other way and saying, 'We will keep the bonds on issue out there even though we do not need them to finance anything. We will keep them out there and with the proceeds we will buy some assets.' Then you get into this awkward business of what assets to buy. You cannot buy Australian fixed interest assets, because there really are not enough of those. Do you buy foreign assets? If you buy foreign assets you suddenly have a new source of demand for foreign currency, which is going to have an effect on the exchange rate. Also, we have the Reserve Bank with official reserve assets, so you are going to have another body with another set of official reserve assets. If you buy domestic assets that are not fixed interest assets, what do you buy? Do you buy equities? You get into the situation where people say, 'You are selling Telstra to buy BHP Billiton.' It is a very complex issue and that is why, I think, the government has done the right thing by putting it out to hear everyone's point of view. We are really in quite uncharted waters. We do not have to make a sudden decision, because any decision is going to be contingent on whatever is the outcome of the possible full privatisation of Telstra.

Ms BURKE—Didn't the bond market in that sense provide a buffer zone there? We saw the aftermath of September 11, where investors flocked back to government investments because it was considered a safe haven. If we get rid of completely safe havens, where do we go in times of uncertainty? Is it not the case, as Alan Greenspan has said, that financial diversity, especially in times of crisis, is something we need within the marketplace?

Mr Macfarlane—I do not know about your first point, but Greenspan was talking about having a corporate bond market. He was saying that countries where businesses rely exclusively on the banking system become very fragile because if something goes wrong with the banking system you would get devastation as happened in Asia. The speech he made—you may remember it—was extolling the virtues of Australia as being a country that has a good corporate bond market or capital market as well as a banking market, so big companies have the choice of going to a bank or issuing in their own names. I do not think whatever happens here would reduce the quality of the corporate bond market. I do not think that is really an issue.

Ms BURKE—If the government did need to raise debt again and we got rid of the bond market, where would they go and would there be a cost in establishing a bond market again?

Mr Macfarlane—I doubt it because the Australian government is such a high-class borrower. This is an argument that used to be used when the Australian government borrowed in its own name in New York and London. There was a belief at that time that you had to keep borrowing a bit each year so your name was known. That is where that idea came from: you borrowed it even if you did not need it just so that your name was there. But the Australian government has not been borrowing offshore in those markets since the late eighties, I think. If the government did need to issue debt, it would just go back to the plain vanilla way of issuing debt, which is the Reserve Bank having a tender every month of Australian government bonds; the bidders would be the Australian institutions: the big Australian commercial banks, investment banks and brokers. They are not going to forget who the Australian government is or what an Australian government bond looks like.

Proceedings suspended from 11.07 a.m. to 11.27 a.m.

CHAIR—Mr Griffin wanted to follow up on bonds.

Mr GRIFFIN—Thank you, Chair. Have you had much comment or consultation from outside the bank regarding the cost of funds issue? Have you heard much from the private sector or from independent advisers on that issue?

Mr Battellino—It is a big issue in the market and yes, we have spoken to people about it. Some analysts have done estimates and they have come up with various conclusions. The situation is so uncertain that it is very hard to know.

Mr GRIFFIN—I understand the point about uncertainty, but is there a trend or a commonly held view, privately or from independent analysts or is there a deal of variation in views coming through to you?

Mr Battellino—There is a variation in views. Probably the dominant view is that the market has become used to pricing everything off Commonwealth government securities. Obviously, if that market is not there, there will have to be some rethinking and change in the way the market operates. As a consequence of that, there might be some widening in spreads, which will lead to an increase in the cost of funds. Really until this happens, nobody knows whether this is going to be an issue.

Mr GRIFFIN—And the estimations vary quite dramatically—is that what you are saying?

Mr Battellino—I think so. Some people are quite relaxed, as far as I can tell.

Ms BURKE—Can we afford the risk of finding out?

Mr Battellino—My personal view is that it is not a huge risk. At the end of the day, there is a lot of talent in the Australian market. We have a very professional market. I find it hard to believe that all that talent could not devote its resources to bringing borrowers and lenders together. At the end of the day, if borrowers want to borrow and lenders want to lend, people will bring them together.

Ms BURKE—Why would they? Why invest the energy and the effort in discovering markets they do not know when they now have a market that they rely upon and sell as risk free? Why waste the time, energy and resources going out to explore unknown markets when they have something there that they are utilising that is working to their advantage? Why would they bother?

Mr Battellino—Because they are already doing that. If you talk to the bond dealers, they will all say that they are not making any money out of trading Commonwealth government bonds. That is such a competitive situation they basically provide that service for free. The money is coming from trading corporate bonds.

Ms BURKE—Would you say that goes across the board in respect of superannuation funds as well?

Mr Battellino—The superannuation funds are different; they are end investors. They are buying the Commonwealth bonds as end investors. A lot of discussion taking place in the market is between the people who are trading the bonds, who are bringing the borrowers and the lenders together.

Ms BURKE—But as an end investor, do you think we would see their capital go offshore?

Mr Battellino—I do not know. If you are going offshore, there is a whole range of other risks that you have to take into account, particularly foreign exchange risks. So I would be very surprised about that.

Mr Macfarlane—I think if you were an investor like a superannuation fund and you had an allocation to go into fixed interest but you could not get Commonwealth government securities, then you would get some other Australian fixed interest that most closely resembled a Commonwealth government security, rather than take on an offshore exposure which is not closely related to Australian fixed interest.

Ms BURKE—But there would still be a cost of going towards other investment products.

Mr Battellino—It is hard to say whether there is a cost or not. Basically, corporate bonds trade at higher yields than government bonds. So the investors who go into those bonds get compensated for buying those. It is not clear at all. It is a different form of investment. Australian institutions were not used to doing that because they never have. There was no corporate bond market for them to invest in, whereas in the last five years—and particularly more recently—if you talked to the institutional investors, all their effort was going into building up corporate debt trading teams. This was something that was not developed in Australia but it is improving very quickly.

Mr GRIFFIN—With respect to the issue of some uncertainty and differing estimates in the private sector and elsewhere, when do you think we will have a better idea of what the likely impacts will be? Is it a situation where we will not know until we actually do it?

Mr Battellino—I think it is going to be the latter. Nobody is going to know until you—

Mr GRIFFIN—So we are working on best guesses in the interim, as best we can, if the government decides to go down that track?

Mr Battellino—Yes.

CHAIR—I move on to the question of bank fees. From the *Reserve Bank Bulletin*, you have shown that total bank's domestic non-interest income since 1997 has shown an average annual increase of 24 per cent, which some have almost suggested might be an abuse of market power. Would you like to comment on this increase and whether or not it is likely to continue?

Mr Macfarlane—Once again, I will hand over to the expertise of Mr Battellino.

Mr Battellino—Just taking a longer term view, the main picture I get from looking at these figures on fees is that the bulk of the growth is coming from rises in the volume of transactions. The fees per transaction have not necessarily changed very much at all. What is happening is—

Mr GRIFFIN—We have had two major announcements over the last 12 months by two of the big four—and I am trying to think; there might have been a third announcement one as well—of major alterations in their fee structures. That would not even come through in your figures yet.

Mr Battellino—The sorts of changes they have had I do not think are really going to impact much on the statistics that we see here. They are changes at the margin. They are rejigging from one fee to another. But overall—

Mr GRIFFIN—Credit Suisse First Boston put out a report—I am not saying it is right—which would suggest that the Commonwealth Bank's fee restructure would slug something like 180 million bucks per annum out of ordinary transaction accounts. That is pretty significant.

Mr Battellino—We will be doing our next fee collection starting in the first half of next year, so as you say, we will wait to see what the actual outcome of that is. One thing that does happen with this is that consumers respond to some extent to the fees in the sense that, if the banks are pushing fees in one direction, consumers are very keen to move to a lower cost product. You see it most particularly in the small business sector.

Mr Macfarlane—This work that we do on bank fees we do because this committee asked us to do it. We are not experts on consumer protection. That is not our role. If you think a particular fee is unfair or it is gouging or something, talk to the ACCC or talk to the consumer affairs organisations in each state. How we got into this was from a very broad macroeconomic viewpoint where we established that the margins on lending had gone down. This committee said, 'We accept that, but have they offset that by putting fees up? Has fee income offset the reduction in margin income?' That is why we had to do this survey, that is why the stuff we do is quite broad brush and that is why we are probably not in a position to answer specific questions like, 'Why did the Commonwealth Bank do this?' or 'Why did ANZ do that?'

Mr GRIFFIN—I understand that but why—

Ms BURKE—And to defend the governor and your bank, we are fully aware of that. There is a requirement that the Treasurer gives the direction to the ACCC to investigate fees and

charges. We are aware of that. He has not chosen to give them that direction, which is unfortunate. To your credit, you have filled in the void and you are the ones on the receiving end. I will apologise to you, but until such time as the Treasurer does the right thing and gives the priority to the ACCC, we do not have anywhere else to go.

Mr KING—Can I take that up because I am not sure—

Mr Macfarlane—Order! Order!

Mr KING—It is true, as you rightly said, that it is not really your role to be dealing with consumer concerns. But if you look at the annual report of the National Competition Council and your annual report, the question of the stability of the financial markets is an issue for you. I am wondering whether or not there is any opportunity for the Reserve Bank to show leadership in relation to competition within the financial markets to see if we can get some better outcomes such as we have had with electricity, gas and even milk? Why not in financial services as well, with some increased competition? There is some concern as to whether or not it is really happening at the moment.

Mr Macfarlane—There is one subset of what you say where we are doing that. The government passed a piece of legislation which set up the Payments System Board of the Reserve Bank and gave it precisely that mandate. It said that we were to look into the efficiency and competition in the payments system. That is one aspect of banking, the various means of making payments—credit cards, debit cards, electronic debiting, crediting, cheques, cash—where we have that responsibility and we believe we are discharging that with great energy. On the broader issue of competition in banking, again I am sorry, but that is not the mandate of the Reserve Bank. It is in fact the mandate of the ACCC.

CHAIR—We might move on.

Mr NAIRN—Mr Battellino commented in responding to the chair that while the actual increase in dollars has gone up by those sorts of figures, fees per transaction have not changed much. Presumably also part of the reason that the dollar value has gone up to the extent that it has is that the banks are now involved in a lot of different areas in which, if you go back five years, they were not and thus were not receiving many fees from. Can you clarify that aspect and also the per transaction aspect as well?

Mr Battellino—Over that period—I forget the number of years we have been collecting this data; I think it is something like four or five years—the collection we have is consistent across the same sorts of products. So we have not branched out into looking at new areas. Certainly, the banks have invested more money into things like funds management, where they are getting fees. But I think in some of the stuff we have published we disaggregate that out and we really look at the fees that are coming directly from transactions, consumer loans and the small business sector and not from the funds management industry, which they are broadening out into.

Mr NAIRN—So the figures that you have produced, which are broken up into fees from households, from business, from small business and from large business, do not actually include things like funds management, insurance and foreign exchange?

Mr Battellino—No, I think they would be a separate issue again. I would have to refresh my memory on that, but I am pretty sure they are not in that group.

Mr NAIRN—Is the other aspect you mentioned about per transaction fairly consistent through each of the areas? Is the reason the figures are as high as they are really the volume of transactions?

Mr Battellino—The volumes are definitely the main reason. From year to year, as Mr Griffin said, banks do rejig some fees. There was a period where they introduced much lower fees for electronic based transactions. Then recently there has been some rejigging of those. I notice that some of those have gone up a little bit. So from year to year they do rejig, but if you had a look at one big factor over the whole period, the thing that stands out is that the volume of transactions grows extraordinarily quickly. It is two or three times the rate of growth in banks' balance sheets.

Mr Macfarlane—We see very clearly that the fastest growing fees are the transaction fees on credit cards and that is volume based.

Mr GRIFFIN—Just to explain myself, one of the reasons why I raised a couple of points earlier was that, although I understand that the bank collects the data at the request of the committee, I did think that some of Mr Battellino's conclusions might in fact be emphasising some things more than others. For example, as you mentioned, you do not cover all fees; a set package of fees, basically, is covered. When you are looking at that question about the degree of transactions versus increases et cetera, what percentage would you say of the actual growth in fee income relates to that question of transaction growth rather than the question of actual increases?

Mr Battellino—I could not answer that off the top of my head. Overall, if you look at it as a proportion of banks' balance sheets, fee income is basically not doing that much. If you do the international comparisons, our banks do not look unusual. The thing is, we have come from a culture where transactions used to be free, so everybody assumed that was the norm. Then we moved into a situation where the banks have started charging fees. But, by international standards, what is happening here is basically normal.

Mr GRIFFIN—Noting full well that your role does not involve the consumer protection issue, but seeing that we are talking in this mode, given that the growth is exponential and although part of it relates to the issue of growth in transactions, have you any thoughts on when we might see it slow?

Mr Battellino—That would depend on how the users of these services respond. People can change their behaviour. Instead of going to the ATM three or four times a week, you go there once a week and get more money out in one hit. People just have to do that.

Mr GRIFFIN—Sure, but you made the point about the fact that the actual market itself is quite sensitive. You mentioned small business in particular. Most of the data that I have seen in terms of surveys and other considerations around the issue of customer behaviour in fact show the opposite. I am a bit surprised by that conclusion. The data that normally comes out about consumer behaviour in those areas, and you mentioned it, actually says that in fact people do not tend to switch around.

Mr Battellino—I think they do—I do not know.

Mr Macfarlane—A lot of it is a generational thing. The older generation stick doggedly to their old ways and the younger generation are proud of the fact that they never set foot inside a bank.

CHAIR—We might move on to the question of credit card fees. As you know, this committee has had an ongoing interest in this for quite a while. We were delighted when the work of the Reserve Bank suggested that we could see a reduction of around 40 per cent in interchange fees charged between credit card companies and financial institutions. I know that the two major international credit card operators are testing this in the court, shall we say. Are you frustrated with the relatively slow movement toward getting these fees down?

Mr Macfarlane—No. We knew that we had to go very slowly, because we knew that we had to have extensive consultation with all the people involved—not just the card schemes and the banks, but the consumers, merchants and anyone who had an interest in it. We were absolutely punctilious in following every step. We knew that that was something we had to do, because international experience had told us that court action was going to be an almost automatic part of the process. We wanted to make sure that our case was unanswerable. We knew that from the beginning. It is not as though it ended up being slower than we thought. We knew that it was going to be slow. We had to be very thorough. We had to have lots of documents produced and lots of opportunity for discussion. We are comfortable with the timetable that is laid out in our final report.

CHAIR—The other question is that, at our hearing earlier this year, we indicated that some of the smaller banks were concerned that the reduction in interchange fees could adversely affect them. Do you have any evidence that this might be the case?

Mr Macfarlane—No, not really. Basically, the credit card market is utterly dominated by the big four. I do not have the numbers in front of me, but I think that the big four have over 90 per cent of the market. Whereas they only have 75 per cent of the Australian banking market, they have 91 or 92 per cent of the credit card market. When you add the No. 5 bank in, they have about 96 per cent of the market. The smaller banks have, in some sense, been almost frozen out of that market under the present system. So we cannot see any way in which it is going to particularly affect them, because they have such a small exposure to it. It is the big banks that have the big exposure to credit cards.

CHAIR—The other question that follows on from that is credit card fraud, which has been mentioned, and skimming, as it is called, which occurs in restaurants in particular. You take a card, skim the details of it and then use it somewhere else. There have been reports that this has increased quite dramatically. In fact, it has increased by 300 per cent. Are you aware of this problem and the extent of it? What is going to be done to try and force banks to update their systems so that you have a more secure card?

Mr Macfarlane—This reminds us that the credit card is a very old-fashioned and quite primitive payment system. It is a technology that goes back to about 1952, and it has not become all that much more sophisticated since then. There are much more modern and sophisticated transaction methods available. For example, the EFTPOS card is much more sophisticated. It is protected by a PIN number, and that is one of the reasons why you do not

hear of it to anywhere near the extent of credit cards. Similarly, electronic debiting and crediting, which is the way forward, the modern way of doing things, is that you use these sophisticated and much more secure ways of making payments. That is one of the things that we want to do. As well as having a more efficient and competitive system, we want technological advances to make it much more sophisticated technologically and, therefore, much safer.

CHAIR—What role does the Reserve Bank have to encourage banks to update their systems to these better ones?

Mr Macfarlane—I do not think we have a role there. John, can you see one?

Dr Laker—No, not in a direct sense. The credit card industry globally is moving to what they call a ‘chip and PIN solution’. This is a much more secure solution and that roll-out will take some time. It will be rolled out to Australia. It is incumbent on the Australian banks to push that process as hard as they can to take advantage of, in a sense, the best practice security technology that is now available. We are not talking about something that will happen overnight. It is a rather large global roll-out and will take several years, if not more.

Mr GRIFFIN—There has been a bit of public speculation regarding retail surcharging post 1 January. I mentioned this last time and we spoke about it briefly then. Do you still have the same view?

Mr Macfarlane—Our view is that it is not going to be a big event. The first thing to remember is that we are not telling anyone that on 1 January they have to do anything. We are not saying, ‘Here is a big event and you have to do something.’ All we are saying is that a current prohibition, which has been imposed by the banks on their merchants, can no longer apply. The merchant is free to do whatever they like. They may do nothing or they may do something. The merchant cannot really say, ‘We are not prepared.’ The merchants are not saying that. The other thing that we should be aware of is that there is already quite a bit of merchants, on big items, passing the cost through to the customers saying, ‘If you are going to cause me to incur this extra cost by using this card, you have to pay more to cover my costs.’ There is already a bit of that going on. It is not meant to happen, because of the agreements between the banks and the merchants, but it goes on. After 1 January, there will probably be more. I do not think there is going to be any big event that is going to happen on 1 January. It will gradually creep in, particularly in those industries which are intensely competitive where margins are very fine. The industry that everyone quotes is the computer industry selling PCs where margins are extremely fine. Those are the sorts of industries where you will start to see it creep in, I think. I do not imagine any big event is going to occur on 1 January.

Mr GRIFFIN—Whose role is it to monitor what occurs?

Mr Macfarlane—There are a couple of aspects where monitoring will become important. We have agreed that later on when the interchange fee goes down, since the interchange fee is part of the merchant service fee, the fee to the merchants should go down and we have agreed to monitor that to see that it is passed through. On the issue of allowing merchants to pass through to their customers the costs that the banks charge them, I am not sure that there really is any monitoring involved there other than if the merchant has incurred a two per cent fee and a member of the public thinks that the merchant is passing on to them more than a two per cent fee, they can complain through all the ordinary channels.

Mr GRIFFIN—What would those channels be?

Mr Macfarlane—It would be the ACCC.

Mr GRIFFIN—Or ASIC.

Dr Laker—To clarify that, we have been working with ASIC and the offices of fair trading in each of the states to look at questions of disclosure if a merchant wishes to—

Mr GRIFFIN—There has been a code released by ASIC?

Dr Laker—There has been a item called *News for business: Merchant pricing for credit card payments* produced by ASIC in consultation with the ACCC, but both agencies have an interest in how this freedom is used. In the first instance, if a customer had a complaint that the governor outlined, that would probably be taken up with the Office of Fair Trading in that state and ASIC would be the overseeing body. So ASIC and the ACCC are the agencies which have the consumer protection role in this area. We are looking at the more general question of the impact of the reforms broadly on merchant service fees.

Mr GRIFFIN—How will you monitor that?

Dr Laker—We are already collecting some data from the banks as part of the regular collection and that will be expanded to look at the level of merchant service fees over time to see how the reforms have impacted on those fees.

Mr GRIFFIN—Will that be on a global basis? How much will you be able to subset that? What I am getting at, to be blunt, is that part of the issue about the way these reforms work is the question of whether they are implemented as was intended. One of the concerns that has been raised in parliament is whether that will be the case and whether there is a capacity to monitor now to ensure that we do not have abuses occurring. There has been some confusion, I think, publicly about who is responsible for what with respect to this. That is what I am trying to get to.

Dr Laker—The Payments System Board has made it very clear that it sees its responsibility is to monitor the impact of the set of reforms—not just the standard on interchange fees—on the fees paid by merchants. We will be looking at that component over time. We will be collecting data from institutions that issue credit cards and acquire credit card transactions and we will be looking at the data from them directly. We have already requested that extra data and we will be able to look at the trend in merchant service fees over time. I think you are also alluding to the question of the pass-through of lower merchant service fees into the general level of prices. That is not an area that we would reach out to look at. We are very confident that market processes will ensure that that is passed through into the general level of prices but in a way that is quite diffuse and not easy to identify very specifically, but the savings are still genuine savings.

Mr GRIFFIN—But you are firmly of the view that it is not your role to look at that?

Dr Laker—The pass-through to the general level of prices?

Mr Macfarlane—I think the answer is that it is just so difficult because we are dealing with very small amounts here. If we reduce the interchange fee by 40 per cent, the merchant service fee might go down by 20 per cent, from two per cent to 1.6 per cent. Only one-third of transactions occurs through credit cards, so that becomes a very small reduction in costs at the level of final goods. Given that we have an inflation rate of 2½ per cent or something, ongoing, and this would be taking off 0.1 per cent, 0.2 per cent or 0.3 per cent, it would be a very difficult task.

Mr GRIFFIN—I understand that, Governor. I have two more questions on this—it is a fairly important issue. Bear in mind that when we are talking about a situation where figures have been trotted out about how much value this reform is going to have to consumers, then that very issue is very important. The second thing is the issue of the banks and the question of whether they absorb, adjust or pass on the impact of these reforms. Do you have a role in monitoring that?

Mr Macfarlane—John has just said that we do, and we will. We will receive information before these reforms come in and then we will receive it at various stages after the reforms have come in to satisfy ourselves that the merchant service fee has gone down as a result of the reduction in the interchange fee.

Mr GRIFFIN—Okay, but with respect to the rest of that, will you be monitoring other aspects of what the banks do in terms of fees in those areas, given that allegations have been made and concerns have been raised about the fact that they will be trying to gouge in other areas to cover the cost?

Mr Macfarlane—That is an interesting argument. That has been used against us by people who oppose reform. They say, ‘You’d better not reform this particular aspect because we know what the banks will do—they’ll just put up the fees elsewhere and they’ll get every dollar of it back.’ If that is the case, that amounts to saying that we have a banking system which has 100 per cent monopoly power; I do not think we have.

Mr GRIFFIN—I think it amounts to saying that, when you make a change, you have to look at the impact.

Mr NAIRN—I am mindful that you might not be able to say too much about the court action, but is there advice from your legal people that you can provide to the committee about how long it is likely to take to resolve these particular actions by Visa and MasterCard?

Mr Macfarlane—I will hand it over to John because he has been speaking to our lawyers, not me.

Dr Laker—I can only really say what is on the public record here and that is that there is a process of directions hearings, which we are undertaking at the moment. The trial, as it is called, is set down for the middle of May next year. I think the suggestion is that it might run for several weeks, but it is too early to tell yet because we are not at a point where evidence is coming forth. That is on a timetable and we are a little ahead of that timetable at this point. All I can really say is that, on the current plans, we expect that the action will begin in the Federal Court by mid-May and it would be lasting for several weeks. I think the court is mindful that there is a timetable for reform of which they would like to be aware as well.

CHAIR—We might move on and touch on household debt. In your annual report it states:

For the first time in half a century, the household sector has a higher level of debt than the business sector. Borrowing for housing accounts for 85 % of household debt.

I think Ms Burke wants to kick off on this.

Ms BURKE—Given that household debt has risen to 125 per cent of disposable household income, are you concerned about this and the soundness of the household balance sheet? Also, the Parliamentary Library has recently done an investigation into family income for the eight Australian capital cities. The library research indicates that in Australia's three biggest cities—Sydney, Melbourne and Brisbane—mortgage payments on the median home bought during the June quarter 2002 are now well in excess of 30 per cent of family income, when borrowing beyond 30 per cent of income is considered to place borrowers under financial stress. In Sydney, repayments on the median home amount to 54 per cent of the median family home income. In Melbourne the figures are 45 per cent; in Brisbane it is 35 per cent. Are you concerned about these results and the exposure of family incomes?

Mr Macfarlane—Let us start with the second question first. I think those figures are misleading. You basically cannot get a loan from a financial institution that will involve you in paying more than 30 per cent of your income as your mortgage payment. With regard to the figures you have got, I think that someone has worked out the average newly taken out mortgage. The average newly taken out mortgages are not being taken out predominantly by people on average earnings. They are being taken out by people on much more than average earnings, but they have expressed that average mortgage payment over average earnings and that is how they have come up with these figures, like the mortgage repayment being 50 per cent of income. That does not mean there are actually people out there on average earnings who are paying 50 per cent on their mortgage. That just happens to be the way those two numbers are being put together.

The issue of household debt is an intriguing one. Every time we have this meeting this is a subject that is brought up and people say, 'Household debt relative to income is going up,' and it is; there is absolutely no doubt about it. Over the last decade, or over the last five years, that has happened. The main reason that it has happened is, as you all know, we now have a low interest rate environment. We started with a high interest rate environment and so people can afford to take on bigger debts because the servicing cost is now more affordable. Is it a worry that household debt is bigger than business debt? I am not sure that we can answer any of those things precisely. We do know that, having learnt from the errors of the last decade, the business sector have been very cautious in acquiring debt during this decade. They have actually gone in a cautious direction whereas the household sector has been willing to take on more risk.

Looking at household debt, I think you quoted that housing makes up most of it—housing is 83 per cent of household debt. So if you are talking about household debt, you are mainly talking about housing. The thing that is astonishing about that—and you may think I am back to a hobbyhorse—is that there are two aspects of household debt. One aspect is owner-occupied debt—in other words, the debt that people take on to buy their own house—and that is 58 per cent of total household debt. Quite astonishingly, 25 per cent of household debt is the debt that people have taken on to buy an investment property. That debt taken on to buy an investment property is the bit that has grown so quickly—it was only nine per cent of household debt a

decade ago and it is now 25 per cent. It has grown much faster than any other category of debt—this is a peculiarly Australian event. That is one of the reasons why we spend a bit of time looking at this, talking about it, wondering whether this is really a sensible use of the nation's resources and whether it is actually going to achieve in the end what the people who have taken out this debt hope to achieve.

Ms BURKE—Is there is a role then for the Reserve Bank to actually advise banks where they should be lending money? Previously, the Reserve Bank through various means has sat down with the big banks and said, 'This is not a sound lending investment. You should be directing your lending to business investment' et cetera. Is it a sound policy and is there some way of putting some brakes on it if, as you rightly demonstrate, there is a growing concern about the issue?

Mr Macfarlane—I am using a certain amount of moral suasion directly to investors, not banks, to try and make them sit back and think again before rushing into the nearest investment seminar that is going to tell them how to get rich quickly. I am trying to use suasion to ask them to think again. Who is talking to the banks? APRA is talking to the banks, and APRA has not only talked to banks but it has talked to building societies and credit unions. It is saying to the banks, 'We want you to go back and do some stress testing. We want you to do stress testing not just on the basis of what has happened in the past, because in the past these prices have continued to go up, but stress testing on other scenarios; for example, scenarios where prices fall by 10 or 20 per cent. We want to make sure that your lending is robust enough so this is not going to cause problems to the banks.' Their brief is to make sure the banks stay sound and in good prudential health. I think they are doing that. What they are doing is very helpful and it is complementary to what we have been doing. But it is not their job to say, 'You should lend more to industry and less to the household sector.' They are not in the game of planning the direction of investment resources, but they are in the game of ensuring greater prudential soundness for the banking system, and that complements the sorts of things that we are doing.

Ms BURKE—Is there then some concern about lending practices and people getting overexposed if you have 83 per cent of your household income in an area that is overexposed? Going back to interest rates, the Australian economy, as you rightly point out, is still doing very well, with the exception obviously of the impact of the drought. Is there some concern or some expectation that in the medium to long run rates will actually go up, given the current trend of the Australian economy? When we have a slight movement in our interest rates, somebody loses their house nowadays. Who is going to put the brakes on—individuals aren't, the banks aren't because they are lending this money, and investors aren't and all the rest of it—so we do not see people lose their homes?

Mr Macfarlane—For a start, let me make it quite clear that owner-occupiers are not anywhere near as highly geared as people who both have their own home and are buying an investment property. They are the people who are highly geared; they are the people who will be hit if one of these scenarios is to occur. Secondly, the normal way that banks make a loan to a potential owner-occupier so that they can buy their own home is that, when the calculations about their ability to afford the repayments are done, the banks load in a bit of fat for the fact that interest rates could go up by 200 basis points or something like that—I am not quite sure of the exact figure. I think the ordinary householder, the person who has an owner-occupier loan, is not vulnerable to a slight increase in interest rates. It will cost them a bit more but they are not

vulnerable; they just tighten their belt a little bit more, as they normally do. It is the people who have taken on the speculative positions who are vulnerable.

CHAIR—Everyone should have got the hint by now.

Mr KING—This discussion has raised something that you mentioned earlier concerning the transfer of risk from the developer to the investor in this context. My impression of what you said earlier is that the transfer of risk does not bring with it potential problems for banks and the lending community. I am a little perplexed about that because, if you are saying that the 25 per cent are pretty highly geared, isn't that going to cause similar risks to banking institutions lending to developers?

Mr Macfarlane—I should clarify what I said before. If a developer presells all the units and people have to put up a 10 per cent deposit then the developer has transferred the first 10 per cent of risk. In other words, if the prices fall by 10 per cent, the developer is unaffected and the investor has to wear it. But if the price were to fall by more than 10 per cent and the investor had committed 10 per cent and walked away, then the extra fall in price would indeed have to be borne by the developer. If that caused the developer to fail then the developer's banker would indeed incur a non-performing loan. It is not as though all the risk has been transferred to the investor but the first tranche of risk—the bit that is most likely to be activated—has been transferred to the investor.

Mr KING—You do not think that has neutral implications for non-performing loans?

Mr Macfarlane—The first implication is that it makes it much easier for developers to just keep developing buildings, and I think it contributes to the oversupply because developers in some sense have taken out an insurance policy for the first 10 per cent of risk—developers know that they will not cop the first 10 per cent. I think that does have the effect of encouraging more development than there would otherwise be, but it does not get rid of the rest of the risk. The risk that would occur if the prices of these things fell by more than 10 per cent would be shared in the first instance by the developer and in the second instance, if the developer fails, by the developer's bank.

Mr SOMLYAY—Following up on Peter King's question, is there any similarity in the experience of people borrowing money three or four years ago to buy shares when the share market was rising compared with the situation now with property? Have people switched from shares to property?

Mr Macfarlane—I will answer that in two parts. People who buy shares on margin—in other words, those who borrow money to buy shares—are in some sense exactly equivalent to people who are negatively geared investors buying property. The difference is that typically margins are much more strictly enforced by the lender. Even on the bluest of blue-chip stocks, the maximum they would lend you is 70 per cent, so you would have 30 per cent of your own equity. The second thing is that stocks are marked to market every day—you see what the price is every day—and, if the price falls such that your equity falls below the 30 per cent that you have guaranteed, there is an immediate margin call. The whole thing is sort of under control on a day-by-day basis. In contrast, when you look at a property investment you make the commitment and then you really do not know what will happen for the next 18 months and, at the end of those 18 months, there is the day of reckoning—you have either made some money

or you have lost some. The other difference is that, with some of these modern financing techniques, people can gear up not just 70 per cent on property but pretty well close to 100 per cent in some cases.

You are right to say that they do have their similarities. They definitely do have similarities; they are both leveraged bets on the price of something going up. They have that similarity. You are also right, I think, to say that, as the first type of investment lost its attraction because the prices fell—that is, investing in shares or particularly leveraged investment became unprofitable—some of the people who did that have looked elsewhere and undoubtedly some of them have moved from that into property.

CHAIR—We will move on to the question of terrorism and money laundering. I know that the Reserve Bank has had responsibility in this area under the Banking (Foreign Exchange) Regulations 1959 and more recently the Charter of the United Nations (Anti-terrorism Measures) Regulations. Obviously AUSTRAC works with you here. I think Ms Gambaro wants to kick off the questioning on that.

Ms GAMBARO—What is your responsibility here? In the latest Reserve Bank report you said you have been working with the FSM, the Financial Stability Forum. I know AUSTRAC has, largely, the responsibility. Can you update the committee on the international developments post September 11 and how you see your role in this, particularly in working with AUSTRAC in freezing the accounts of known terrorists or terrorist groups?

Mr Macfarlane—After September 11 the government, in an international effort, decided that if they could identify the bank accounts of terrorists or people supporting terrorists then they would like to block those bank accounts. In fact, a number of names were transmitted from the US to Australia. At that time the only way that these accounts could be blocked was by them asking us to use the Banking Act's foreign exchange control mechanism. That could not even block the account completely; it basically blocked international transactions from the account. We obviously cooperated fully with the government to do that. It was only a partial solution because it only blocked international transactions. Legally, the person who held that account had every right to take the money out in Australian dollars and spend it how they saw fit.

Ms GAMBARO—You could not freeze it?

Mr Macfarlane—No, we could not freeze it. These are very old regulations that go back to the Second World War. The government then introduced some new legislation, which the chairman read out and which is more effective and is administered by the Department of Foreign Affairs and Trade. We no longer have a role. The new regulations apply to any restrictions that are imposed within the United Nations framework. The freezing of accounts of terrorists was within the United Nations initiative and so all that is now effectively done through that channel. We still have a very small residual role in freezing accounts where the decision is a unilateral decision rather than one that has been taken through United Nations cooperation. Most of the work is now done directly by the Department of Foreign Affairs and Trade.

Ms GAMBARO—You probably cannot answer this, but are the methods being used by terrorist organisations becoming more sophisticated?

Mr Macfarlane—I can answer that but it is very second hand. I can tell you what I have heard from other people who are involved in it. The first thing that the experts will tell you is that it actually does not cost very much to run a terrorist organisation. The initial expectation that somehow or another you will be able to chop off the source of finance and therefore the terrorist organisation would cease to exist has proved not to be the case. In fact, the monitoring of these financial flows and accounts is really more useful in a different sense in that it helps you in the detective work of tracing where the money went and capturing people who have been engaged in terrorist activities. It is very useful, but in a different way than was originally envisaged.

Ms GAMBARO—Is there anything that can be done to protect Australian businesses from dealing unknowingly with terrorist groups, or engaging unknowingly in these sorts of transactions?

Mr Macfarlane—I do not know; I am sorry I cannot answer that one.

CHAIR—As you know, we have invited people to email questions to the governor, and we do have a few here. Rather than using those—given the time—I would like to put a question to you. We have a number of students here from schools in the region. Shae Spry from Portland Secondary College has given me a question that I would like to put to you, Mr Macfarlane: with banks being privatised, that is, there is no commercial bank with the Commonwealth now being fully privatised, do the banks still, in your opinion, serve the needs of rural communities and the everyday person? You look lost for words.

Mr Macfarlane—Students always ask the most difficult questions. Let me approach it from the beginning where we talk about the difference between government owned banks and privately owned banks. Around the world over the last 30 or 40 years, somewhat surprisingly, the government owned banks got into more trouble than the privately owned banks. We saw that here. We saw the State Bank of Victoria come to grief; we saw the State Bank of South Australia come to grief. They were two very big and important banks in their local communities. On the other hand, we saw the Commonwealth Bank put in a very good performance during the 1980s. Of the three biggest government owned banks during that period, two of them managed to go broke. Why is that so?

The answer that most of the bank regulators would give is that making loans is a very risky business. It is very hard to keep monitoring whether the banks are doing it wisely or whether they are taking excessive risks. For all its imperfections, the stock market is actually a better way to monitor it than any other. The general view would be that, for example, the State Bank of Victoria, which was a wonderful and venerable institution for most of its life, lost its way and started doing extremely risky things through a subsidiary, Tricontinental. If it had been a listed bank, people would have spotted that and would have started to sell the shares. The share price would have gone down, it would have rung a very big alarm bell for the management at the bank and they would have started to do something about it. Because there was not any of this external pressure—there were not armies of analysts looking at it from day to day—the stock market was not delivering a verdict. That particular form of risky behaviour was allowed to go on and on until it eventually brought the bank down. The case of the State Bank of South Australia is almost identical.

For those reasons, most countries around the world that had government owned banks and privately owned banks came to the conclusion that it was just too risky continuing to own government owned banks. That is the main reason why we do not have virtually any government owned banks now in Australia. Far from being safer than privately owned banks, they proved to be riskier than privately owned banks in the decade of the eighties and that led to their demise. So now we are left with a banking sector that consists of privately owned banks. Are they allocating funds efficiently to the various sectors of the economy? I suspect that they are doing it is about as efficiently as any other way that has ever been managed to be devised. It is honestly not going to be perfect, but they are doing it as about as well as can be devised.

If we are worried about, for example, lending to the rural community, in a proper competitive system, if that is not being done well, some new entrant will come in and start to do it. I think we have seen that in rural lending—we have seen Rabobank, which has been so successful in the Netherlands, come in and become a specialist rural lender. There are others, too—Elders Bank has come in. So I think in the long run you are more likely to get an efficient allocation of capital or an efficient flow of lending into the rural sector under the sort of circumstances that we have now than under the circumstances we had before.

CHAIR—Thank you. Are there any burning questions?

Mr SOMLYAY—I have a question that does not concern the topic we have been speaking about. There is a meeting of COAG today—I think in Canberra—and that brings to my mind monetary policy and fiscal policy where the federal government is producing budget surpluses. In my own state of Queensland the state government has just produced a \$900 million deficit for the current year. How much impact on monetary policy does it have when the state governments produce deficits and the Commonwealth government is still trying to produce a surplus, particularly at a time when this property boom is filling up the state coffers with stamp duty?

Mr Macfarlane—Deficits or surpluses of the sizes you have mentioned either at the state or the federal government level are actually not, under the current system that we operate in this country, material to monetary policy. There was a time—basically pre 1982—where the federal deficit, in particular, was of enormous influence on monetary policy, because that was a period when the government, if it had a deficit, could borrow from the Reserve Bank. Rather than issuing debt into the market, it would simply borrow from the Reserve Bank, which is what is colloquially known as ‘printing money’. In that era, in the Reserve Bank we spent more time looking at fiscal policy and the budget surplus than we did looking at monetary policy. But with the present set of institutions in place, if the government runs a deficit, it has to borrow from the public dollar for dollar at market-determined interest rates to cover that deficit, it does not have any immediate impact at all on our monetary policy. One could imagine that, if it was really huge, it might start to have an influence on long-term interest rates or something like that, but for the sort of order of magnitude that we are looking at the moment, it does not really have any impact. It is even more so for state governments, because state government deficits never did have any direct effect on monetary policy, other than if they were very large. The states, of course, never had the option of borrowing from the Reserve Bank—the states always had to borrow in the marketplace to cover any deficit.

It could have an effect if it were done on a large enough scale in the sense that it might push up long-term bond rates, but we would have to be talking about very big orders of magnitude—five per cent, six per cent or seven per cent of GDP—before you started to see any sign there. It

ive per cent, six per cent or seven per cent of GDP—before you started to see any sign there. It would not affect what we were doing with our monetary policy; it would affect interest rates at the long end of the yield curve. So it might at the margin push up long-term bond rates, but not of the orders of magnitude we are talking about now.

Mr KING—I have one last question on the drought. In circumstances where farmers are having to pay substantial funds to buy and feed stock or, if they have sold their stock, to restock at the end of the drought—let us say it happens in April or May next year—do you think there is a role for the Reserve Bank with respect to encouraging the commercial banks not to apply commercial risk principles and foreclose in circumstances where you have a strong productivity market? If you give the farmers an opportunity to stay in business, they are likely to trade out of it in favourable market circumstances. Is there a role for the bank?

Mr Macfarlane—I do not think there is a role for the Reserve Bank. Our act does not give us the power to tell the commercial banks to do very much at all. At the moment the only part of our legislation that really gives us power over commercial banks is specifically related to the transactions in the payment system. I think if the government felt that the banks were not being sympathetic to farmers or were taking too short run a point of view it would be up to the government to use its influence and its moral suasion on the banks, rather than the Reserve Bank.

Ms BURKE—Can I go back to interest rates. With the exception of the rural sector, the Australian economy is doing very well. Is there a concern that leaving interest rates low will overheat the economy, consistent with the dangers you outlined at our last hearing? If it is the case that you have concerns about the inflationary impacts of that, when will we see interest rates go up?

Mr Macfarlane—This question has been asked before in a different form.

Ms BURKE—I know it has, but not as directly.

Mr Macfarlane—You certainly stated what we told you at the last meeting. That was, we felt, the biggest risk at that time. If the world economy had continued to recover at the pace it had been recovering in the first half of the year, that indeed would have been the major risk. That is why we felt it was important to prepare people for the fact that interest rates should go back up to normal. As you know, and as I have said at great length, that did not happen. The world economy really turned around, and started to weaken then for the second half of the year. In addition, we discovered we had a drought. So we have sat back and done nothing—just sat at that level, because we think that is now the appropriate level. But if next year we discover that the world economy is going to pick up and grow faster than our current forecasts suggest, then we would get back onto the track that I talked about in May.

Ms BURKE—What about wages impacts on inflation? Wages have tracked all right, but we are reading that there is a little concern from what you have put in there that there might be an impact on wages and wages growth.

Mr Macfarlane—That is something we had in mind—not in the front of our minds but in the back of our minds—in May. At the moment, we do not think that wages are a significant risk. It is true that in some sectors wages are going up quite fast. In some parts of the mining areas of

Western Australia we are aware that they are going up extremely quickly, and there are probably other pockets, but we would always expect that that would be happening in some areas. In other areas, they would be going very slowly. What we are interested in is the average, and the average seems to be consistent with our inflation target.

Ms BURKE—Sorry to do this, but at page 10 of your November statement, you have a comment reflecting ongoing concerns about financial fragility in the corporate sector, about things being attractive overall in the economy, but with there seeming to be an underling concern about the corporate sector. Is there something there that is a risk. It is page 10, long-term interest rates.

Mr Macfarlane—We are talking about the US corporate sector and the European corporate sector. Indeed, we have been very conscious of the fact that some areas of the corporate sector in those countries are under types of strain we have not seen before. In the US, we know we had all these problems with corporate governance and we know that companies were overstating their profits and overstating their revenue. We know that even some companies that have not been doing any of those things are now encountering some problems they never foresaw.

The biggest example of that is the traditional household name companies in the US like General Motors, Ford, Goodyear and what have you who have defined benefit superannuation funds which are now unfunded or not fully funded. They were meant to be fully funded. When share prices were going through the roof, they were overfunded, and the companies, as they had every right to, were taking back the overfunding. Now that the share market has collapsed, these superannuation schemes are underfunded. The schemes really have first call on any increase in profits. That is suddenly a new drain on US corporate profitability that people had not envisaged three or four years ago. In Europe, we see problems with the same thing in some of those companies. We also see problems with the European insurance sector. Yes, this is one of the big uncertainties. Are these just something that a little bit of growth will cause to go away, or are they much bigger? We do not really know.

Ms BURKE—You do not think they have any impact on the Australian corporate system or our super fund exposure? Given HIH, where the royal commission is going and corporate governance, you do not think that some of that reflects onto what is happening in the Australian sector?

Mr Macfarlane—I do not think we are anywhere near as exposed. At the moment, APRA is doing a survey of defined benefit schemes in Australian companies. I have not seen the results of that yet. We think it is on a very much smaller scale than in the US. We had our big insurance collapse, and it was not related to the boom and bust in share markets, as you know; it was related to much more deep-seated problems. Obviously, that was a very big vulnerability in the system which has now been taken out of the system. With most of the measures of things like gearing, the Australian corporate sector is more cautious and more prudent than the US corporate sector. Even more important is corporate profitability. Profitability of the Australian corporate sector is much healthier than in the US corporate sector.

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

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

CHAIR—I thank everyone for today. It has been a particularly good hearing. I thank the Governor of the Reserve Bank, other members of the bank, the committee, Hansard and everyone who has come along to see this hearing and the way it is conducted. I hope that you have all got something from it and that from that you will have a better understanding of the interaction between the parliament and the Reserve Bank—some of it anyway.

Committee adjourned at 12.39 p.m.