The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia annual report 1999-00: Interim report: the Wagga Wagga Hearing

House of Representatives
Standing Committee on Economics, Finance and Public Administration

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Foreword

The committee was delighted that its December 2000 meeting with the Reserve Bank of Australia was held in a regional setting for the first time. We are grateful to the Governor and his staff for supporting this move, and to Mrs Kay Hull MP (Federal Member for Riverina), Mr Kevin Wales (Mayor of Wagga Wagga) and the people of Wagga Wagga for their assistance with the hearing. To enshrine this event we have sub-titled this report the *Wagga Wagga Hearing*.

Whether held in Sydney, Melbourne or now in a regional centre, these RBA hearings continue to attract considerable interest and attention from the Parliament, the community and the financial media. The hearings have proved to be an excellent avenue of transparency and accountability for the Bank. However, the committee continues to strive for ways to improve this process.

At the hearing the Bank reported that we had '…avoided the boom-bust cycle in economic policy, and hence have an excellent outlook for the coming year…' However, it stressed that this should not lead to complacency and outlined some of the potential risk areas for the economy. While heartened by the Bank's positive outlook, the committee found a number of the risk factors identified very worrying and vigorously pursued many of those matters in more detail. Issues examined include: the world economy, the exchange rate, business confidence and the effects of the new tax system. The interest rate reductions in both the US and Australia since the hearing confirm the accuracy of the Bank's cautionary remarks.

As well as focusing on monetary policy the committee also looked at several important aspects of the payments system. The recent report by the Reserve Bank and the Australian Competition and Consumer Commission which examined interchange fees for the first time, was looked at in considerable detail. We are pleased to hear of their work with the financial institutions to reduce charges attached with the use of credit and debit cards.

The committee continues to appreciate the assistance and cooperation of the Governor and his staff. We also acknowledge the advice provided by Mr Chris Richardson (Chief Economist, Access Economics), Dr John Edwards (Chief Economist, Hong Kong-Shanghai Banking Corporation) and Dr Steven Kates (Chief Economist, Australian Chamber of Commerce and Industry), in the lead-up to the hearing.

Finally, I thank the members of the House Economics Committee for their contributions to the hearing and this report.

David Hawker MP
Chair

Membership of the Committee

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Terms of reference

The Standing Committee on Economics, Finance and Public Administration is empowered to inquire into and report on any matter referred to it by either the House or a Minister, including any pre-legislation proposal, bill, motion, petition, vote on expenditure, other financial matter, report or paper.

Annual reports of government departments and authorities tabled in the House stand referred to the relevant committee for any inquiry the committee may wish to make. Reports stand referred to committees in accordance with a schedule tabled by the Speaker to record the areas of responsibility of each committee.

The *Reserve Bank of Australia annual report 2000* was tabled in the House of Representatives on 5 September 2000, and the *Payments System Board annual report 2000* was tabled on 8 November 2000.

List of abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ATM	automated teller machine
AWOTE	average weekly ordinary time earnings
CEDA	Committee for the Economic Development of Australia
CLS Bank	Continuously Linked Settlement Bank
DoFA	Department of Finance and Administration
GST	goods and services tax
IMF	International Monetary Fund
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
TWI	trade weighted index
WCI	wage cost index

List of recommendations

Recommendation 1

The Committee recommends that the Australian Bureau of Statistics investigate methods for ensuring the sample used for calculating the CPI includes regional areas and implement the appropriate changes to achieve this. (para 2.67)

1

Introduction

Background

1.1 The biannual appearance of the Governor of the Reserve Bank of Australia (the Bank) before the House Economics Committee has become a focus for accountability and transparency for the Bank. This report on the Bank's activities is the tenth in the series that began in 1994, providing a continuous period of public scrutiny of monetary policy.

1.2 There are two bases for the Governor's appearance before the committee. The first is the August 1996 *Statement on the conduct of monetary policy,* agreed between the Treasurer, the Hon Peter Costello MP, and the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane. This statement formalised the Bank's accountability framework through the publication of a statement on the conduct of monetary policy and the Governor's biannual appearance before the House Economics Committee.

1.3 The second basis for the appearance of the Reserve Bank is the House of Representatives' Standing Order 324 (b), which provides for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make.

1.4 Each appearance by the Reserve Bank attracts great interest from the parliament, the financial sector, the media and the community.

Scope and conduct of the review

1.5 At its meeting on 17 August 2000, the committee resolved to hold its next public hearing with the Reserve Bank in early December 2000 in Wagga Wagga.

1.6 The hearing, held on Friday 1 December 2000, was the first to be held outside the financial and administrative centres of Sydney, Melbourne and Canberra, and prompted intense interest from the Wagga Wagga community. Both the committee and the Governor agreed that the selection of a regional location represented a very good precedent, and expressed an expectation that some future hearings would also be held in regional areas. In fact the Governor encouraged a more adventurous choice of regional location in the future.

1.7 Both the committee and the RBA recorded their appreciation to the Mayor of Wagga Wagga, Mr Kevin Wales, for the civic reception that he hosted for the Governor and the committee prior to the public hearing.[1] The committee would also like to thank Mrs Kay Hull MP, Member for Riverina, and her office for their assistance in ensuring the success of this hearing.

1.8 As with the last hearing in Melbourne in May 2000, the committee invited local tertiary and senior secondary students to attend the hearing. On this occasion, a number of students from Wagga Wagga High School and Trinity Senior High School attended the hearing. The committee has also fortunate to be assisted prior to and during the hearing by Mr Anthony Trentini, a work experience student from St Michael's Regional High School in Wagga Wagga.

1.9 Discussions at the public hearing were based on the Bank's and Payments System Board annual reports and the Bank's *Statement on monetary policy November 2000*.[2] The report, *Debit and credit card schemes in Australia: A study of interchange fees and access*,[3] produced jointly by the Bank and the Australian Competition and Consumer Commission (ACCC), was also considered during the hearing.

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1 Evidence pp 1-2.

2 *Reserve Bank of Australia annual report 2000*. Sydney, RBA, 107p; Reserve Bank of Australia. 2000. *Payments System Board annual report 2000*. Sydney, RBA, 46p; and Reserve Bank of Australia. 2000. *Statement on monetary policy November 2000*. Sydney, RBA, 52p.

3 Reserve Bank of Australia and Australian Competition and Consumer Commission. October 2000. *Debit and credit card schemes in Australia: A study of interchange fees and access.* Sydney, RBA, v 82p.

1.10 The committee regularly holds private briefings with noted economists prior to each public hearing. On this occasion, the committee was briefed by three economists: Mr Chris Richardson, Chief Economist, Access Economics; Dr John Edwards, Chief Economist, Hong Kong-Shanghai Banking Corporation; and Dr Steven Kates, Chief Economist, Australian Chamber of Commerce and Industry. These briefings presented to the committee some alternative views on monetary policy, the Australian economy, the exchange rate, and business confidence.

1.11 As with previous reports of this kind, this report focuses on the matters raised at the public hearing, including monetary policy and the operations of the Bank. The report does not aim to repeat details of the Bank's S*tatement on monetary policy November 2000*.

2

Conduct of monetary policy

Review of forecasts presented in May 2000

2.1 The hearing began with the Governor reviewing the Bank's forecasts for the economy that he outlined at the May 2000 hearing.

2.2 The Bank had forecast 4% growth in the 1999-2000 financial year, a minor slowdown from the 4.5% growth in 1997, 1998 and 1999. In the end, the outcome was 4.7% growth. This continued what the Bank described as '…our tradition of modest underestimates of economic growth.' [1] However, the Bank added that '…these underestimates have not been by design'.[2]

2.3 In May 2000 the Bank predicted the CPI would rise by 3% in the year to June 2000, whereas the actual outcome was 3.2%. It pointed out that while the difference is not very big, it represented a break with past forecasts in that the outcome was higher than forecast. It attributed this result to the higher-than-expected oil prices.[3]

2.4 A longer term inflation prediction also was provided to indicate the trend after the 'once-off' lift to the price level attributable to the GST had passed through. In May 2000 the Bank suggested inflation could be in the upper half of the 2-3% range well into 2001/02. However, the November 2000 statement forecast it to be around 3% by that time, primarily due to the lower exchange rate prevailing at the time of the hearing compared with the middle of 2000.[4] Again there was a bit of an underestimate.

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1 Evidence p 2.

2 Evidence p 2.

3 Evidence pp 2-3.

4 Evidence pp 2-3.

2.5 In summary other forecasts were for: signs of tightening in labour market conditions; falling unemployment; and higher consumer inflation expectations, partly as a result of the impending introduction of the GST. The November figures indicate a significant decline in the unemployment rate and fast growth in employment; while inflationary expectations declined back to the levels prevailing in early 1999.[5]

2.6 Overall the Bank reminded the committee that Australia is still in the longest expansion we have had for three decades and it expected the expansion to continue into its tenth year.[6] As predicted, this was confirmed by the figures from the September quarter national accounts.[7] Characteristics of that period were: an average growth rate of 4.2% pa; annual rates between 3%-5%; a low level of inflation - a major factor behind the expansion's longevity; and a fall in the unemployment rate of nearly 5 percentage points to 6.3%.[8] This is a good result in anyone's terms.

2.7 However, the Bank stressed that this good record should not lead to complacency.[9]

Prospects for 2001

2.8 In looking to the future the Bank expected some modest slowing from past growth rates to June 2001 and a small increase in inflation well into 2001/02.

2.9 The Bank indicated that it concurred with the revised Treasury forecast of about 4% growth for the year to June 2001, as the Bank’s forecasts already envisage a slowdown in GDP growth compared to the 1999-2000 year.[10] The forecast involves a substantial slowdown in domestic demand from about 6% to 3%, which is mostly offset by further gains in net exports (assuming that inventory rundown recorded over the past year does not occur again).[11]

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5 Reserve Bank of Australia. May 2000. *Semi-annual statement on monetary policy May 2000*, Sydney, RBA, pp 1-2, 21-23 and 46-48 and Reserve Bank of Australia. Nov 2000. *Statement on monetary policy November 2000*, Sydney, RBA, pp 1, 29-31 and 47-48.

6 Evidence p 3.

7 Treasurer. *National accounts: September quarter 2000*. Press Release No. 112. 13 December 2000. 2p.

8 Evidence p 3.

9 Evidence p 3.

10 Evidence p 2.

11 Evidence p 2.

2.10 As previously indicated, inflation is expected to be around 3% by the end of 2001 and likely to remain at that level sometime thereafter.

2.11 In summary the Bank stated that we have '…avoided the boom-bust cycle in economic policy, and hence have an excellent outlook for the coming year…'[12]

2.12 In discussing its predictions for the future, the Bank outlined in considerable detail where the risks to that outlook are likely to arise. It stated that because the economy is in reasonable balance, the risks are on both sides, that is, circumstances that could lead to a stronger economy and hence a speed-up in inflation and other factors that could lead to a slower rate of economic activity than the current figures indicate.

2.13 In relation to the inflation outlook, the Bank said that there is still the risk that the temporary factors of: the GST-induced lift to the price level; the rise in oil prices; and the fall in the exchange rate, might push the Australian economy off course if it was more buoyant than expected.[13]

2.14 On the other hand, three risks that the outlook for economic activity could be weaker than currently expected, were highlighted.[14]

2.15 First, the world economy is a concern, especially the United States. While for some time most commentators have expected a lower growth in 2001 for both the world economy and the US, this slowdown could be sharper than expected, particularly if there is a shake-out in asset prices.

2.16 Second, a big contraction in housing construction has been expected for some time due to a lot of housing activity being brought forward to get in before the GST. However, this cycle in housing could be more pronounced than anticipated. The rise in interest rates have also had an impact here.

2.17 Third, a drop in business confidence. In December 2000, business confidence was not as high as it was a year ago. The Bank said it believed the fall it was seeing in December 2000 owes a lot to: the realisation that the housing and construction sector will be weak; the number of businesses that have only recently had to face up to the practical implementation of paying the GST; and rising petrol prices.

2.18 While the committee was heartened by the Bank's positive outlook, it found a number of the risk factors very worrying and probed several of these matters vigorously, as discussed later in this chapter.

12 Evidence p 6.

13 Evidence p 3.

14 Evidence pp 2-3.

2.19 At the hearing the Bank also outlined in much more detail some of the approaches that it uses in assessing likely developments in the economy.

2.20 It reported that as well as assessing statistical information, using econometric models, undertaking extensive liaison with industry, examining leading and lagging indicators or the forecasts embodied in financial prices etc, it finds the following two approaches important.[15]

2.21 First, it goes back and examines previous expansions and asks what were the imbalances that brought about their demise. It then assesses whether those imbalances exist at present. Second, it looks at how the present setting of policies is affecting the economy.

2.22 It stressed that these two approaches are just techniques that it finds helpful as part of an overall assessment. The committee found this information interesting and useful in understanding the Bank's forecasting approach. However, the committee remains concerned that the Bank continued to underestimate the rate of growth and the implications this has had, and could have, for interest rate changes. The committee noted that in August 2000, the Bank specifically stated in relation to its consistent under-estimates of the strength of the economy that:

> …the Reserve Bank has under-estimated the strength of the Australian economy, while its critics have under-estimated by a larger margin.[16]

World economy

2.23 At the hearing the committee examined the implications of the international situation for Australia in considerable detail.

2.24 The Bank reported that for some time most observers have expected lower growth for the world economy in 2001 than achieved in 2000. Such a change has also been expected in the US which contributes 23%of the world economy. More specifically, in its November statement, the Bank reported that '…The IMF expects world growth to slow in 2001 from 4.5% to 4% as growth in the US slows from around 5% to 3%, but still remain

15 Evidence pp 5-6.

16 Macfarlane, I. 2000. A medium term perspective on monetary policy. *Reserve Bank of Australia Bulletin*, September 2000, p 3. (Address given to *Queensland University of Technology Business Leaders' Forum, Brisbane, 10 August 2000*).

above its long-term average.'[17] At the hearing the Bank said it supports the majority view. It still described this as a very good growth rate.[18]

2.25 The concern is whether or not after such a long period of expansion the US can achieve a soft landing. In December the Bank predicted the odds pointed in that direction.[19] In late 2000 evidence of the slow down was coming through. More recently the Federal Reserve Board lowered its target for the federal funds rate by a total of 1 percentage point to 5.5%. This involved a 0.5% reduction on 3 January and a similar cut on 31 January 2001. Reasons given for the 3 January 2001 reduction were:

> These actions were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions on segments of financial markets, and high energy prices sapping household and business purchasing power. Moreover, inflation pressures remained contained. Nonetheless, to date there is little evidence to suggest that longer-term advances in technology and associated gains in productivity are abating.[20]

Reasons given for the 31 January 2001 decrease were:

> Consumer and business confidence has eroded further, exacerbated by rising energy costs that continue to drain consumer purchasing power and press on business profit margins. Partly as a consequence, retail sales and business spending on capital equipment have weakened appreciably. In response, manufacturing production has been cut back sharply, with new technologies appearing to have accelerated the response of production and demand to potential excesses in the stock of inventories and capital equipment.
>
> Taken together, and with inflation contained, these circumstances have called for a rapid and forceful response of monetary policy…[21]

2.26 In its February 2001 statement, the Reserve Bank reported that most commentators are now pointing to a weakening of the international conditions. The US is likely to have a period of considerably lower growth and this has led to a reduction of their expectations for global growth.[22]

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17 *Statement on monetary policy November 2000* p 4 *and* Evidence pp 7-8.

18 Evidence p 10.

19 Evidence p 4.

20 Federal Reserve Release. *Press release, January 3, 2001.* 1p.

21 Federal Reserve Release. *Press release, January 31, 2001.* 1p.

22 Reserve Bank of Australia. 2001. *Statement on monetary policy February 2001.* Sydney, RBA, p 1.

2.27 At the November hearing the RBA also noted that the pessimism with regard to Asia that had arisen around the time of the hearing was being exaggerated. While it considered such pessimism may be appropriate in relation to Thailand, Indonesia and the Philippines (which have a great deal of political instability), it suggested it was not warranted in the case of Japan, China, Korea and Taiwan - our big export partners.[23] However, in its February 2001 statement the Bank stated that the shift downward in global growth expectations was reinforced by concerns about the durability of the recovery in Japan.[24]

2.28 As previously outlined, oil prices were cited as a major risk factor. In the November statement the Bank stated that the price for oil had reached its highest sustained level since the Gulf war. However, at the hearing the Bank commented that the impact on petrol prices is not as big in proportionate terms as the OPEC 1 and OPEC 2 oil price shocks in the 1970s. [25]

2.29 The Bank noted that the percentage increase from the period preceding the rise was from a low base ($US10) which was exceptional and temporary. However, over most of the 1990s the oil price was $US20 a barrel that has now risen to $US35 and put about a 1% increase onto the CPI in most countries. However, the RBA does not expect contractionary effects like there were in the previous two oil shocks for two reasons. First, the increase is so much smaller, and second, a lot of countries that are the beneficiaries of the increases in the price of oil (eg Russia, Indonesia, Nigeria, Mexico and Venezuela) go straight out and spend the money. This contrasts with the behaviour of the beneficiaries (ie desert sheikhdoms) in the previous oil shocks.[26]

2.30 Regarding fuel prices, the Bank is expecting that the 1% CPI increase mentioned above, will not be repeated.[27] In its November statement the Bank stated that:

> …At present, the Bank (like most other forecasters) assumes that oil prices will decline somewhat in 2001, helping to bring about a partial reversal of the petrol price impacts on the CPI observed over the past year.[28]

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23 Evidence p 10.

24 *Statement on monetary policy February 2001* p 1.

25 *Statement on monetary policy November 2000* pp 4-5 and 10-11 especially Graph A1 p 10 and Evidence pp 24-26.

26 Evidence pp 24-25.

27 Evidence p 25.

28 *Statement on monetary policy November 2000* pp 2-3.

Economic growth

2.31 As well as a slowing in domestic growth in 1999-2000 there has been a big change in the composition of that growth with weak house building and very strong exports. However, the Bank stressed that the good thing is that the housing sector is about 5% of GDP while exports are about 20% of GDP. It noted that this factor is not always recognised as much as it might be by the media.[29]

2.32 The value of exports grew by almost 30% over the year to the September quarter, reflecting both higher export prices and robust volume growth. The Bank considered this an extraordinarily high figure.[30] The growth has been in all categories of exports and is spread across all major destinations. This has been achieved despite Japan (our largest export market) being stagnant for the last decade.[31] The Bank considered next year would again be a good year for exports, despite the unfortunate effects of the drought and floods in various parts of Australia in the later part of 2000.[32]

2.33 Also of significance is the fact that the weakening housing sector was predictable. In its November statement the Bank noted that household spending on dwellings reached record levels as a percentage of GDP in the first half of 2000. This was strongly influenced by the incentive to complete as much work as possible prior to introduction of the GST.[33] However, the Bank said this is merely a continuation of the cyclical nature of the building industry.

2.34 In addition, in Australia productivity (whether labour or multifactor) has picked up in the 1990s. It has risen faster than productivity in the US - although from a lower base. To the extent that this is happening the Bank said, it contributes to a higher potential growth rate and given that the labour force is not growing as fast as it did a decade ago, the two factors are not cancelling each other out. This means that the potential growth rate maybe a little higher than earlier estimates.[34]

29 Evidence p 9.
30 Evidence p 9.
31 Evidence p 13.
32 Evidence p 13.
33 *Statement on monetary policy November 2000* pp 24-26.
34 Evidence p 32.

Business confidence

2.35 The committee raised concerns about the decline in business confidence from the highs of 1999. It was especially concerned in relation to small business. The Bank noted that while all 13 surveys of business confidence indicated a drop in the level of business confidence in the later part of 2000, it has not come down in a way that would alarm it because the loss is nothing particularly startling. In most cases the decline is not as great as in 1998, 1996 or 1995.[35]

2.36 In relation to small business, the Bank noted the sharp decline in business confidence of this group as indicated by the Yellow Pages survey and noted the lack of a clear explanation for this.[36]

2.37 The Bank pointed out the vagaries of the statistical surveys used to indicate business confidence, such as: the nature of the questions asked in the surveys; their lack of statistical thoroughness; the particular constituencies of some of the surveys; and the lack of scientific explanation for the results.[37]

2.38 Accordingly, the committee asked the Reserve Bank to examine this matter further and report back at the next hearing. Mr Macfarlane concurred.[38] Specifically the committee is looking for: an examination of the adequacy and effectiveness of the existing surveys of business confidence; and the reasons for the recent drop in confidence among small businesses.

Impact of fiscal policy

2.39 Questions were again asked about the adequacy of the current stance of fiscal policy and its effects on monetary policy. Again the Bank clearly stated that '…the current stance of fiscal policy is not imposing a contractionary influence on the economy at all.'[39] It stressed that: Australia's fiscal policy is credible; it is the fourth year of budget surplus; Australian governments can borrow at almost the same terms in Australian dollars as the US government can borrow in US dollars; and that none of the traditional circumstances (eg high inflation, a wage surge,

35 Evidence pp 14-15.

36 Evidence p 14.

37 Evidence pp 14-15.

38 Evidence p 15.

39 Evidence p 6.

overvalued asset prices or excessive physical investment) in which fiscal policy can have big implications for monetary policy exist.[40]

2.40 The Bank again acknowledged that the previous budget did provide a stimulus to the economy, whether:

> …through good luck or good management, the timing is very nice because it is helping to keep the economy on a growth path that we think is a good growth path.[41]

2.41 The Governor repeated that he would be concerned if there was a bidding war in relation to the next election. He indicated that '…If it was on a very small scale, you could not complain, but at some point, yes, it would be very dangerous.'[42] He also stressed that '…I think it is important that governments run surpluses.'[43]

2.42 In response to questioning the Bank also acknowledged that if it thought fiscal policy was making it difficult for it to do its job, it would make the appropriate comments.[44]

Effects of the new tax system

2.43 At the hearing the Bank reported that the GST induced lift in the price level was easily foreseeable and appears to have gone according to plan or better.[45] It also stated that the jury is still out on the assumption that the GST will be a once-off lift and that it will not feed through to ongoing inflation. However, it believes that this still looks like the most likely outcome.[46]

2.44 Inflation statistics indicate that price increases in the September quarter are lower than expected by most predictions.[47] The Bank was asked whether this indicated that businesses had absorbed much of the GST effect themselves and, if so, whether the long term impact of this would be a matter of concern.

2.45 The Bank responded that the result could have come about through the influence of three distinct factors: first, the original estimates were simply

40 Evidence pp 10-12 and 18.
41 Evidence p 12.
42 Evidence p 12.
43 Evidence p 12.
44 Evidence p 45.
45 Evidence p 3.
46 Evidence pp 8-9.
47 *Statement on monetary policy November 2000* p 43.

wrong; second, a greater effect from wholesale sales tax reductions than anticipated; and third, that businesses had absorbed all or part of the increases and did not let them flow into product prices. The Bank believes there is probably some element of truth in all three explanations with the answer revealed by future quarter figures.[48]

2.46 In its November statement the Bank highlighted that the wage cost index (WCI) and average weekly ordinary-time earnings (AWOTE) measures continue to provide differing pictures of wage developments.[49]

2.47 Despite that, the Bank is continuing to work on the assumption that there will not be a secondary effect of the GST in wages, that is, the workforce accepts that reductions in taxes and the increase in welfare benefits offset the rise in the GST. At present the Bank reported that wages are growing between 3%-4% which is consistent with the inflation target. It said that its monitoring of enterprise bargains for the inclusion of clauses about the need to increase wages to compensate for the GST, has revealed few cases where such a clause is included. However, a big CPI effect is needed to trigger it.[50]

2.48 The committee again raised concerns about the level of executive salaries and the increases to bonuses and share schemes. These latter elements are not included in the Mercer Cullen Egan Dell salary review which indicated that, based on the September quarter figures, executive pay has been relatively stable and risen by 4.5% over the past year. The Bank said it remains puzzled by the high level of executive salaries.[51] So does the committee.

Exchange rate

2.49 At the hearing the Governor answered a number of questions on the exchange rate, particularly issues arising from his November speech on this topic.[52]

2.50 At the outset the Bank emphasised that a fall in the exchange rate was one of the risk factors to be assessed in monetary policy. It is almost undeniable, the Bank said,that the level of the Australian dollar at the time

48 Evidence pp 9 and 31.

49 *Statement on monetary policy November 2000* pp 46-47.

50 Evidence pp 5 and 29-30.

51 Evidence pp 30-31 and *Statement on monetary policy November 2000* p 47.

52 Macfarlane, I. 2000. Recent influences on the exchange rate. *Reserve Bank of Australia Bulletin*, December 2000, pp 1-6. (Address given to *CEDA Annual General Meeting Dinner, Melbourne, 9 November 2000*).

of the hearing was making export and import competing industries super-competitive, and hence exerting an expansionary influence on the economy.[53]

2.51 The Bank said it agrees with the majority of people who say that '…the Australian dollar is actually undervalued and that, for the overall balance of the economy, it would be better if it were not as undervalued as it is…'[54] Despite this being great for exports, the RBA said there has to be a balance.

2.52 The Bank agreed with the committee's comment that in the six months prior to the hearing the Australian dollar depreciated against the American dollar and Australia's inflation forecast has increased. However, the Bank noted that the Australian dollar has not depreciated against the TWI to the same extent that it has against the US dollar.[55]

2.53 In looking for explanations for this, the Governor elaborated on statements made in the CEDA speech. He noted in the period July-August until early October, it was difficult to get a clear explanation. Three reasons were expounded however. These were: first, a strong US dollar; second, momentum - exchange rates do follow momentum; and third, a number of investors were influenced by the new economy - old economy distinction. This was a period when you had to go beyond the normal traditional explanations for an exchange rate movement. [56]

2.54 In response to a question on the new economy-old economy distinction for Australia, the Bank acknowledged that there has been a tendency for people to make very quick, superficial, judgements on that issue and Australia has suffered unfairly.[57] In response to other questioning about the drop in Australia's spending on R&D, long term productivity measures and outputs and growth in new industries in Australia in the long term, the Governor said that '…I am enormously in favour of doing what we can…There are lots things that can be done…'[58]

2.55 The Bank stressed that contrary to alternate views it has '…a consistent approach to monetary policy where the exchange rate does play a role…'[59]

2.56 On foreign exchange intervention the Bank stressed that it does believe that:

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53 Evidence pp 3 and 6.

54 Evidence p 16.

55 Evidence p 17.

56 Evidence pp 17-18.

57 Evidence p 20.

58 Evidence pp 26-27.

59 Evidence p 19.

> …foreign exchange intervention can be very useful and effective as long as it is done sparingly and you do not get overanxious. The evidence that we have not been overanxious this year is that we watched the currency come down from US65c at the start of the year, and the intervention we have done, which has been done relatively recently, was done only when it was below US55c.[60]

2.57 The Bank said it is prepared to intervene if it believes: first, that the exchange rate has departed a long way from the fundamentals; and second it is moving further away in thin trading conditions and likely to register another misleading observation in a destabilising direction. The Bank confirmed that it does not have a particular level of the dollar that it holds to, as this would probably lead to ineffective intervention. It also acknowledged that it has 'jawboned', but not a lot, and it also engages in 'preparations for intervention' when market prices are taken.[61]

2.58 In response to a question on expectations of an improvement in the value of the Australian currency through to the new year the Governor said he did not wish to profile this, but '…I think the chances are quite good.'[62]

2.59 In its February 2001 statement the Bank reported that:

> With the recovery of the Australian dollar from its lows in November, the Bank has remained out of the market, except for a few occasions in December and January when market liquidity was seasonally low and the Bank intervened on a small scale to ensure that the exchange rate did not behave erratically in thin conditions.[63]

Interest rates, inflation and monetary policy

2.60 In its November statement the RBA reported that the upward trend in short-term market interest rates that began in mid-1999 had levelled out in the past six months; the expectations for a further monetary tightening was low; and this was reinforced by better than expected inflation data.[64]

2.61 At the hearing the RBA said that its assessment of risks was that it:

> …will continue to conduct monetary policy according to the medium term principles contained in our inflation targeting. We

60 Evidence p 19.

61 Evidence pp 19-20 and 23-24.

62 Evidence p 23.

63 *Statement on monetary policy February 2001* p 16.

64 *Statement on monetary policy November 2000* p 36.

> think this approach has served the economy extremely well, not only in the direct sense that it has maintained low inflation, but in a wider sense that it has provided preconditions for sustainable growth…[65]

2.62 At the December 2000 hearing, in commenting on how the present setting of policies was affecting the economy, the Bank noted that as well as looking at changes in interest rates, you need to look at the level of interest rates in nominal and real terms, and ask whether their present setting involves a significant risk that the economy will overheat or contract.

> …As you know a year ago we thought that the continuation of the then setting of interest rates would risk the former outcome. That is why we moved to our present setting, which we would characterise now as being more or less in the neutral zone - that is, not presenting either of the two risks to any substantial extent. Because it is in this zone, there is no overwhelming case to move it in a particular direction at present…you could not claim that the current setting of interest rates is inhibiting the growth of the economy.[66]

2.63 At the hearing the Bank also noted: the slowdown in world growth; the expectation - not a certainty but some probability - that the next move in US interest rates would be downwards; and that Australia's expectations of further rises in interest rates continued a lot longer than the US.[67] As previously outlined the US undertook a 1% reduction in interest rates in January 2001. In its February 2001 statement the RBA noted the 3 January 2001 reduction was the first inter-meeting move since October 1998 and the first 0.5% cut since the early 1990s recession.[68] In addition, it was the first reduction in interest rates since 17 November 1998.

2.64 Despite the RBA's neutral statement on monetary policy at the committee's December hearing, by 7 February 2001 the circumstances had changed and the Bank board concluded:

> …the balance of risks had shifted sufficiently that an easing of monetary policy was appropriate, and hence cash rates were reduced by 50 basis points, to 5.75 per cent. As with previous policy decisions, the move was intended to promote sustainable growth of the economy consistent with the inflation target.[69]

65 Evidence p 4.

66 Evidence pp 5-6.

67 Evidence pp 6-8.

68 *Statement on monetary policy February 2001* p 9.

69 *Statement on monetary policy February 2001* p 3.

2.65 During the hearing questions also were asked about whether the sample used by the Australian Bureau of Statistics (ABS) for the compilation of the CPI, is representative.[70] The Bank said this was a matter for the Australian Bureau of Statistics (ABS).

2.66 According to ABS documentation, the CPI measures price changes in the spending patters of all metropolitan private households. The Bureau defines metropolitan as all the State capitals, Canberra and Darwin.[71] In other words, the CPI does not measure price changes in regional areas. The Committee believes that CPI data should be measured using a more representative sample that includes regional areas.

Recommendation 1

2.67 **The Committee recommends that the Australian Bureau of Statistics investigate methods for ensuring the sample used for calculating the CPI includes regional areas and implement the appropriate changes to achieve this.**

70 Evidence pp 21-22.

71 Australian Bureau of Statistics. 2000. *A Guide to the Consumer Price Index: 14th series.* Canberra, ABS, p 3.

3

Other matters

Transparency

3.1 The transparency of the Bank's decision making processes has always been a major concern for the committee. At the hearing, the committee again raised the question of the release of the Bank's Board meeting minutes. The Governor again indicated that he was not convinced there is a strong case for the release of minutes.[1]

3.2 The Bank pointed out that the information it puts out when it makes a change in monetary policy is very important, as it is real time information released immediately the decision is announced. Board meeting minutes would take at least two weeks to release. In addition, the account of the meeting would most likely take into account the criticisms of the media and the market to the direction of monetary policy.[2]

3.3 The Bank also indicated that the possibility of it issuing a statement when it does not change interest rates was not a good idea.[3]

3.4 The independence of the Bank's Board was also raised during the hearing. The Bank confirmed the committee's understanding that the Reserve Bank of Australia is the only central bank in the OECD on which a treasury official sat as a Board member.[4]

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1 Evidence p 42.

2 Evidence p 42.

3 Evidence p 40.

4 Evidence pp 39-40.

3.5 In relation to adverse comments on monetary policy by government ministers, the Bank indicated that such comments are an indication that the Bank is independent of government influence.[5]

3.6 In early January 2001 there were several articles, a letter and a media statement expressing the views of Professor Adrian Pagan who completed his term on the RBA Board in November 2000.[6] As well as being reported as commenting on some critical internal RBA board decisions about interest rates, Professor Pagan argued for reform and changes to the RBA board structure. In summary he noted that, over the past decade, in many countries, as the methods of setting monetary policy have changed, a new institution has often been created to perform that task. While this happened in both the Reserve Bank of New Zealand and in the UK, where a Monetary Policy Committee was set up, this did not happen in Australia after the 1996 changes to monetary policy. After outlining some detail on how the current RBA board operates, Professor Pagan set out what he described as a modest proposal for improving the board.

3.7 The committee was surprised by the apparent tone and breach of confidentiality by a former Board member. The committee intends to follow-up in a serious way the workings of the RBA Board and will investigate further the principles raised in this matter.

RBA State offices

3.8 A major focus for the RBA's Banking Department over the past year has been to position the Bank to manage the effects of the Government's competition policy on the market for transactional banking services.[7]

3.9 In line with the Department of Finance and Administration's (DoFA's) banking devolution guidelines, agencies are beginning to undertake the task of market testing their banking services. As at 30 June 2000, five agencies had completed market testing. Three chose to move to the private sector and two elected to remain with the Bank. The Bank was requested by DoFA to develop a market testing kit to simplify the process

5 Evidence pp 39-40.

6 Cleary, P. RBA rate split revealed. *Australian Financial Review*, 8 January 2001; Cleary, P. Without reservation. *Australian Financial Review*, 8 January 2001; Pagan, A. *Monetary policy not "Sydney-centric". Media statement,*8 January 2001; Pagan, A. Board keeps the RBA broad-based. *Letter to the Australian Financial Review*, 9 January 2001; Pagan, A. Bring on the fresh Reserve. *Daily Telegraph*, 9 January 2001.

7 *Reserve Bank of Australia annual report 2000*. Sydney, RBA, p 39.

for agencies to undertake market testing. The coming year is expected to see the majority of agencies complete the exercise. The outcomes of this process are likely to lead to further adjustments in the Bank's banking operations in the period ahead.[8]

3.10 The combined effects of declining business volumes, technology and centralisation have significantly reduced the role of the Bank's branches in providing banking services.[9]

3.11 The Bank reported that the volume of note processing has also diminished considerably as a result of the improved durability and security of polymer notes and the effect of changes in the distribution arrangements for the notes.[10]

3.12 Overall:

> …The combined impact of these reductions in activity in the banking and note issue functions led to a situation where staff numbers in branches were falling below what was considered to be the minimum viable size in terms of security and staff management...[11]

3.13 The Darwin and Hobart RBA branches were closed in 1997 and 1998 respectively, and the Melbourne, Brisbane and Perth branches were closed in late 1999.[12]

3.14 The Bank used the hearing to announce a new initiative to retain some representation by the Bank in the states. An office of the Economics Group of the Bank will open in all states except Tasmania. This will mean new offices in Perth, Brisbane and Melbourne. The Melbourne office will also cover Tasmania. In the other state capitals, the offices will be housed in existing Bank premises.[13]

3.15 The offices will consist of two professionals, the chief representative and an assisting economist, plus a back office. The offices will be involved in economic research and analysis. Each of these state offices will have a program of visits to regions in the state. They will feed information back to the Economics Group, which will form part of the assessment of how

8 *Reserve Bank of Australia annual report 2000* p 40.
9 *Reserve Bank of Australia annual report 2000* p 39.
10 *Reserve Bank of Australia annual report 2000* p 39.
11 *Reserve Bank of Australia annual report 2000* p 39.
12 Evidence p 28.
13 Evidence p 28.

the economy is performing and become part of the forecasts of how the economy will perform in the future.[14]

3.16 The Governor indicated:

> …We think that when this system is fully operational…we will be in a much better position to receive information from other states and regions than we have ever been in.[15]

3.17 The Bank has already made the appointments and the offices were up and running by January 2001.[16]

3.18 The committee strongly supports this expansion of the Bank's economic research activities, and believes this may assist in counteracting the perception that the Bank is too Sydney-centric.

Interchange fee study

3.19 In September 1999, the Reserve Bank of Australia and the Australian Competition and Consumer Commission (ACCC) announced a joint study into interchange fees for debit and credit cards. Interchange fees are fees that flow between financial institutions whenever customers of one institution are provided with card services by another institution.[17]

3.20 A major motivating factor for the study was the Financial System Inquiry's recommendations on card schemes.[18] Other motivating factors included previous ACCC attempts to change fee structures to reflect attributable costs, and complaints to the ACCC and the Bank by merchants.[19] The report was delivered in October 2000.

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14 Evidence pp 28-29.

15 Evidence pp 28-29.

16 Evidence p 28.

17 Reserve Bank of Australia. 2000. *Payments System Board annual report 2000*. Sydney, RBA, p 11; see also Reserve Bank of Australia and Australian Competition and Consumer Commission. October 2000. *Debit and credit card schemes in Australia: A study of interchange fees and access*. Sydney, RBA, p 26.

18 Financial System Inquiry. March 1997. *Final Report*. Melbourne, FSI, pp 393-400.

19 RBA and ACCC p 4.

ATMs

3.21 Interchange fees for automatic teller machine (ATM) transactions are paid by the card issuer to the financial institution that operates the ATM. They are designed to reimburse the ATM owner for the costs incurred in providing a cash dispensing service to the issuer's customers. The fees were reached by bilateral negotiations in the late 1980s.[20]

3.22 On the information provided, interchange fees average $1.03 per transaction. This is double the cost of providing the service, which is about $0.49. Card issuers normally pass these fees onto their card holders whenever they use another institution's ATM through foreign ATM fees, at an average of $1.35 per transaction.[21]

3.23 If the market were working effectively, competition between providers would be expected to bring fees more into line with the costs of providing these transactions.[22]

3.24 According to the Payments System Board:

> …the study has shown that the industry's current cost structure provides ample scope to reduce fees for cardholders who use the ATMs of other financial institutions..[23]

Credit card networks

3.25 In credit card networks, interchange fees are paid to the card issuer by the merchant's financial institution.[24]

3.26 In Australia, the interchange fees for domestic transactions are agreed jointly by the financial institutions which are members of each of the card schemes. The average interchange fee for credit cards, including both electronic and paper transactions, is 0.95% of the cost of the transaction.[25]

3.27 The study found that there is on average a 39% mark up over the cost of providing the transaction for credit card issuers. There is a 67% mark up over cost for the credit card transaction aquirer.[26]

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20 RBA and ACCC p 33; see also *Payments System Board annual report 2000* p 12.
21 RBA and ACCC pp 33-34; see also *Payments System Board annual report 2000* p 12.
22 *Payments System Board annual report 2000* p 12.
23 *Payments System Board annual report 2000* p 13.
24 *Payments System Board annual report 2000* p 14.
25 *Payments System Board annual report 2000* p 11; see also RBA and ACCC p 43.
26 *Payments System Board annual report 2000* p 11; see also RBA and ACCC p 44.

3.28 The study reviewed the costs incurred by issuers that might reasonably be included in an interchange fee. Based on this assessment, the study could not find any justifiable grounds for charging an interchange fee of more than half the current average.[27]

3.29 The interchange fees are generally passed on to the merchants through merchant service fees. Merchants cannot pass on the merchant service fee to the user of the credit card, but instead pass these fees on to all customers in the form of higher prices. In this way, credit card users are being subsidised by other customers. These rules suppress important price signals to end users about the cost of using credit cards, and give consumers choosing payment methods the impression that the cost of credit card transactions is zero.[28]

Debit card payments

3.30 Interchange fees for debit card payments are negotiated bilaterally and are paid by the card issuer to the merchant's financial institution. Major banks negotiated their interchange fees about a decade ago. The interchange fees are flat fees that average about $0.20 per transaction.[29]

3.31 Merchant and interchange fees taken together average about $0.32 per transaction, while costs are $0.26 on average.[30]

3.32 The study concluded that there was no convincing case for an interchange fee in either direction, instead financial institutions offering debit card payment systems could seek to recover card payment service costs directly from their own customers.[31]

Interchange fee study outcomes

3.33 The study found that interchange fees in all three card networks in Australia are higher than needed to recover the relevant costs of financial institutions, and that these fees are not reviewed regularly.[32] The regulatory authorities have adopted two approaches to reforming the interchange fee structure.

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27 *Payments System Board annual report 2000* p 11; see also RBA and ACCC p 59.

28 *Payments System Board annual report 2000* p 16.

29 *Payments System Board annual report 2000* pp 18-19.

30 *Payments System Board annual report 2000* p 11; see also RBA and ACCC pp 61-62.

31 *Payments System Board annual report 2000* p 11; see also RBA and ACCC pp 66-70.

32 Evidence p 35; see also *Payments System Board annual report 2000* p 20.

3.34 In relation to credit cards, the ACCC is pursuing an authorisation process under the *Trade Practices Act 1974* in order to ensure that financial institutions which are members of credit card schemes regularly review and set interchange fees using an acceptable cost based methodology and make their analysis and results public.[33]

3.35 The Bank reported that the majority of banks appeared to support the ACCC process. At the hearing, the Bank also warned that if the banks did not cooperate, the Payment System Board might be forced to designate a credit card scheme:

> ..I do not see the status quo on credit cards continuing, and I think it is up to the banks to decide which of the paths they want to go down.[34]

3.36 In relation to the use of ATMs and debit cards, the Bank stated that it would be looking for the banks:

> …to come to a system which was transparent so people could see what other people are being charged…[35]

3.37 Overall, the Bank stated:

> …We have done the study, we have put it on the table and we have said to the industry that the current arrangements are not efficient. We want a response from the industry and we will work with them, taking into account the views not just of the financial participants but of the users, retailers or people affected by these various card schemes.[36]

3.38 The committee welcomes the report and expects to see major progress with reform by the next public hearing in May 2001. The committee will closely monitor progress on this issue.

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33 *Payments System Board annual report 2000* p 18.

34 Evidence p 34.

35 Evidence p 35.

36 Evidence p 37.

Payments system developments

3.39 Apart from the interchange fee study, three payments system developments attracted the attention of the committee: the Continuously Linked Settlement (CLS) Bank; progress on three day cheque clearing; and the new Charter for Direct Debit Customers.

3.40 The Payment System Board has strongly supported the global initiative, started in 1997, to reduce foreign exchange settlement risk through the establishment of a CLS Bank. The CLS Bank will be a settlement intermediary providing a simultaneous payment versus payment mechanism for foreign exchange transactions in eligible currencies. Around 60 banks active in the foreign exchange market are developing the CLS, including Australia's four major banks. The development of the CLS Bank has been slower than expected, with the Bank expected to become operational towards the end of 2001. The Australian dollar will be one of the settlement currencies adopted from day one.[37]

3.41 Recently, the Chairman of the Payments System Board wrote to the chief executives of institutions that had not originally met the three day cheque clearance standard to follow up on their progress in cheque clearing. Eight additional banks have now moved to a three day cycle, bringing the total to 26 banks. However, a number of banks still have a four day cycle or longer, although some have indicated that they will move to the best practice model in 2000-2001.[38] At the hearing, the Bank indicated that technology issues were delaying those banks that had not already moved to a three day cheque clearing cycle. The Bank also indicated that there is now sufficient choice in the market for customers who want a three day cheque clearing cycle.[39]

3.42 Although popular abroad, Australians have been reluctant to adopt Direct Debit as a means of payment. The Bank speculated that the reluctance is caused by the current incentives to use credit cards for bill payments, and Australian consumers not having the confidence that they will be able to stop any incorrect payments under a direct debit arrangement. The Payments System Board has come up with a Charter for Direct Debit Customers to encourage the use of this system of payment. Most importantly for the consideration of the Payments System Board, the charter confirms that customers will be given adequate notice of debits to

37 *Payments System Board annual report 2000* pp 37-38; see also *Reserve Bank of Australia annual report 2000* p 37.

38 *Payments System Board annual report 2000* p 28; see also Evidence p 33.

39 Evidence p 33.

be made to their accounts and will be able to stop the debit if they believe they have been incorrectly billed.[40]

3.43 The committee supports the three above initiatives.

David Hawker MP
Chairman
26 February 2000

40 *Payments System Board annual report 2000* p 24.

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Appendix A – List of Hearings, Briefings and Witnesses

Public Hearings

Friday, I December 2000 – Wagga Wagga

Reserve Bank of Australia

Dr John Laker, Assistant Governor (Financial System)

Mr Ian Macfarlane, Governor

Mr Glenn Stevens, Assistant Governor (Economic)

Private Briefings

Thursday, 9 November 2000 - Canberra

Mr Chris Richardson, Chief Economist, Access Economics

Monday, 27 November 2000 – Canberra

Dr John Edwards, Chief Economist, Hong Kong-Shanghi Banking corporation

Dr Steven Kates, Chief Economist, Australian Chamber of Commerce and Industry