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Review of the Reserve Bank of Australia *Annual Report 2002*

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

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Contents

Foreword

In August 1996, the Treasurer and the Governor of the Reserve Bank of Australia agreed that the Governor would appear before the Committee twice each year to report on the conduct of monetary policy. These public hearings are the only occasions on which the Governor is obliged to publicly answer questions about Bank policy, including on interest rates. The hearings have therefore played a valuable part in enhancing community understanding of the Reserve Bank's role.

The hearings have also played a positive part in helping business and investors plan for better productivity growth. Nothing dents confidence like sudden surprises and to date, since the hearings began, any such unexpected changes have been modest and rare. However, a possible contradiction of the better public understanding is that one sometimes wonders whether public speculation on RBA future decisions takes more prominence than in the past when other economic matters appeared to receive more attention.

This report concludes the Committee's review of the Bank's *Annual Report 2002*. The Committee conducted two hearings in support of the review – at Warrnambool in regional Victoria in December 2002, and at the University of Melbourne in June 2003. As ever, the hearings attracted considerable attention from the public and market commentators, and were well-attended by students keen to hear first-hand the factors taken into account by the Bank in its decisions on monetary policy.

The public hearings coincided with a long period of stable official interest rates, which at that time had remained unchanged since June 2002. Issues examined at the hearings included the impact of the world economy on Australia, the unusually high level of speculative investment in housing, and – at the June hearing – recent rapid appreciations in the value of the Australian dollar. These last two issues, and the conflicting demands they place on monetary policy, remain topical and will be examined at the public hearings for the Bank's *Annual Report 2003*, along with anticipated progress on reforms to Australia's payments system.

On behalf of the Committee I would like to thank David Richardson from the Parliamentary Library, and Geoff Dodd from the House of Representatives Liaison and Projects Office, for their continued work in support of the public hearings. I would also like to thank Mr Alan Oster from the National Australia Bank and Dr John Edwards from HSBC for the private briefings they gave the Committee before each of the two hearings. Likewise, the strong support of all Committee Members and the Committee Secretariat ensure the ongoing strength of the hearings.

Finally, I would like to thank the Governor of the Reserve Bank, Mr Ian Macfarlane, and his staff for their continued support for the public hearings, and to congratulate the Governor on his recent re-appointment for a further three years. Mr Macfarlane's seven-year tenure has coincided with a remarkable period of uninterrupted economic growth and stable interest rates. In light of the rise in official interest rates in November 2003 – the first increase in 17 months – the next public hearing with the Bank, to be held in Brisbane on 8 December 2003, will provide an important opportunity for the Governor to elaborate on the reasons for the increase and on the future challenges for monetary policy and related issues.

David Hawker MP
Chair

Membership of the Committee

Chair Mr David Hawker MP

Deputy Chair Ms Anna Burke MP

Members

Mr Anthony Albanese MP

Mr David Cox MP
(from 10 December 2002)

Ms Teresa Gambaro MP

Mr Alan Griffin MP

Mr Peter King MP

Mr Mark Latham MP
(to 10 December 2002)

Mr Gary Nairn MP

The Hon Alex Somlyay MP

Dr Andrew Southcott MP

Committee Secretariat

Secretary	Mr Trevor Rowe (to February 2003)
	Mr Russell Chafer (from February 2003)
Inquiry Secretary	Ms Susan Cardell
Adviser	Mr David Richardson
Administrative Officers	Ms Katie Hobson
	Mr Shane Read

Terms of reference

The House of Representatives 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's *Annual Report 2002* was tabled in the House of Representatives on 28 August 2002; the Payments System Board's *Annual Report 2001* was presented to the President of the Senate on 28 March 2002; and the Payments System Board's *Annual Report 2002* was presented to the President of the Senate on 28 March 2003.

List of abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ACCC	Australian Competition and Consumer Commission
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATM	Automatic Teller Machine
CAD	Current Account Deficit
EFTPOS	Electronic Funds Transfer at Point of Sale
GDP	Gross Domestic Product
IMF	International Monetary Fund
NSW	New South Wales
RBA	Reserve Bank of Australia
UN	United Nations
US	United States

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Introduction

Background

1.1 The House of Representatives Standing Committee on Economics, Finance and Public Administration is responsible for monitoring the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the financial sector and the community as a whole.

1.2 The Reserve Bank Governor's appearances before the Committee at biannual public hearings are an important element of the Bank's accountability framework. These biannual appearances are provided for by two means:

- the August 1996 *Statement on the Conduct of Monetary Policy*, agreed between the Treasurer, the Hon Peter Costello MP, and the Governor, Mr Ian Macfarlane.[1] The statement formalised the Bank's accountability framework and the biannual appearance before the Committee; and
- the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. The House Economics Committee may inquire into

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1 A second *Statement on the Conduct of Monetary Policy* was released in July 2003, building on the 1996 Statement. Both documents can be viewed on the RBA's website at www.rba.gov.au/MonetaryPolicy.

aspects of the annual reports of the RBA and the Bank's Payment Systems Board.[2]

1.3 The biannual hearings typically coincide with the release of one of the RBA's quarterly statements on monetary policy. At the December 2002 hearing in Warrnambool and the June 2003 hearing in Melbourne, the Committee scrutinised the RBA's *Statement on Monetary Policy* for November 2002 and June 2003 respectively.

1.4 As with previous reports, this report focuses on matters raised at the public hearings. The report does not repeat in detail the commentary in the RBA's *Annual Report* and statements on monetary policy. These documents may be viewed through the Bank's website.[3]

Scope and conduct of the review

1.5 The Committee held two public hearings following the tabling of the RBA's *Annual Report 2002*. The first was held in Warrnambool in Victoria on 6 December 2002. The second hearing was held at the University of Melbourne on 6 June 2003.

1.6 Proceedings for both hearings were streamed live over the internet through the Parliament's website, allowing anyone interested in the Governor's evidence to hear the proceedings as they occurred. The transcripts of the hearings are available on the Committee's website.[4]

1.7 Before each of the hearings the Committee received a private briefing from a prominent economist – on 5 December 2002 from Mr Alan Oster, Chief Economist of the National Australia Bank, and on 29 May 2003 from Dr John Edwards, Chief Economist of HSBC Bank Australia. The briefings were of great assistance to the Committee in highlighting issues for discussion at the public hearings.

1.8 Members of the public were invited to submit questions to be put to the Governor at the Warrnambool hearing. In addition, several students from secondary schools and universities accepted the Committee's invitation to attend the two hearings and, through the Committee, to put questions to the Governor.

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2 The mandate of the Payments System Board is to promote safety, efficiency and competition in the payments system in Australia, and to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets. See further discussion in Chapter 3 of the Board's role in relation to credit card reform and bank fees.

3 www.rba.gov.au/PublicationsAndResearch/.

4 www.aph.gov.au/house/committee/efpa/rba2001-02/ph.htm (as at July 2003).

1.9 These opportunities to enhance community understanding of the work of both the Parliament and the RBA are one of the most important aspects of the biannual hearings. The Committee will continue to provide opportunities for public involvement at future hearings.

1.10 The two hearings conducted outside Melbourne, Sydney or Canberra – the Warrnambool hearing and the December 2000 hearing in Wagga Wagga in NSW – have played a valuable role in involving regional Australia in the parliamentary committee system, and have given the RBA an opportunity to address perceptions that the regions are not taken into account in decisions on monetary policy. The Committee welcomes the Reserve Bank Governor’s strong endorsement of these regional hearings.

1.11 The Committee intends to conduct every second public hearing with the Governor outside Sydney or Melbourne, as circumstances permit. The next hearing (the first for the RBA’s *Annual Report 2003*) will be held in Brisbane on Monday 8 December 2003.

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Monetary policy and related issues

Review of forecasts presented at the 2002 hearings

2.1 At the May 2002 public hearing held in Sydney (for the Committee's review of the RBA's *Annual Report 2001),* the Governor of the RBA, Mr Ian Macfarlane, advised the Committee of expected GDP growth for the 2002-03 financial year of between 3.5 and 4 percent. The hearing was preceded by the first increase in official interest rates since August 2000, from 4.25 to 4.5 percent, followed on 5 June 2002 by a further increase to 4.75 percent.

2.2 The Governor's candid advice at the May 2002 hearing was that the increase earlier that month was likely to be the start of a process of returning official interest rates to "a more neutral setting", as "the outlook for economic growth and inflation is such that the economy no longer needs the boost provided by an expansionary stance of monetary policy".[5]

2.3 However, the cash rate subsequently remained unchanged from the June 2002 increase until November 2003, when the rate was increased by 0.25 percent.[6] At the first of the hearings for the Bank's *Annual Report 2002*, held in Warrnambool in December 2002, the Governor noted that forecast GDP growth for 2002-03 had been revised down to

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5 *Official Hansard*, 31 May 2002, Sydney, p.3. See further discussion of the Governor's view of official interest rates under "normal" economic conditions at *Official Hansard*, 6 December 2002, Warrnambool, pp.10-12.

6 See "Statement by the Governor, Mr Ian Macfarlane: Monetary Policy", 5 November 2003 at www.rba.gov.au / MediaReleases / mr_03_15.html (as at November 2003).

3 percent due principally to the drought but also, to some extent, to a weaker world economy than had been anticipated[7] (paragraphs 2.10 to 2.17 refer).

2.4 At Warrnambool the Governor presented an updated forecast for economic growth of 3.75 percent for the 2003 calendar year, based on an assumption of a recovery from the drought in the second half of 2003, and a forecast for underlying inflation for the calendar year of approximately 2.75 percent (a slight downward revision to the figure advised in May 2002, due again to lower forecasts for world and Australian economic growth).[8]

2.5 At the June 2003 hearing in Melbourne the Governor presented a further update of those forecasts. He noted that the RBA, in its May 2003 *Statement on Monetary Policy*, had slightly reduced its underlying inflation forecast for the calendar year from 2.75 to 2.5 percent, due largely to the higher exchange rate for the Australian dollar (see further discussion of the inflation outlook at page 12).[9] On economic growth, the Governor advised that:

> …growth through the [2002-03] financial year will be close to the 3 percent forecast, or perhaps a little bit below it. We only have one more quarter of data to receive and then we will know the answer to that. As we look slightly further ahead, however, prospects are not as strong as they were. Instead of 3¾ percent through calendar 2003, we now think the figure will be more like 3 percent.[10]

2.6 Average economic growth for 2002-03, following release of the June quarter National Accounts, was 2.75 percent. GDP growth for the quarter stalled at 0.1 percent (for a final figure for 2002-03 of 2 percent), following a substantial fall in exports attributed to factors including weak world economic conditions, the drought, recent appreciations in the currency (see page 22), the war in Iraq and the SARS epidemic.[11]

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7 *Official Hansard*, 6 December 2002, Warrnambool, p.4.

8 *Official Hansard*, 6 December 2002, Warrnambool, p.4.

9 *Official Hansard*, 6 June 2003, Melbourne, pp.42-43; Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.53.

10 *Official Hansard*, 6 June 2003, Melbourne, p.42.

11 The Hon Peter Costello MP, “National Accounts: June Quarter 2003” (Media release, 2 September 2003), at *www.treasurer.gov.au/tsr/content/pressreleases/2003/076.asp?pf=1* (as at September 2003).

2.7 Mr Macfarlane attributed the reduced forecast for economic growth for the 2003 calendar year to the weaker performance of the world economy, and the subsequent negative effect on Australia's trade performance.[12] The RBA, in its May 2003 *Statement on Monetary Policy*, had noted that the decline in aggregate exports had been offset by an "exceptionally rapid" expansion in domestic demand. The combination of strong domestic demand and a weak external sector had resulted in a substantial widening of the Current Account Deficit (CAD) over the preceding year.[13]

2.8 In response to questioning from the Committee at the June hearing, the Governor noted that the CAD had widened to 5.3 percent of GDP:

> I will be very surprised if it does not go over 6 [percent] at some stage later this year. That is a pattern that we have had in Australia for 20 years or more: when we are doing well and the rest of the world is doing badly, our current account deficit goes over 6 percent. People could say, 'That's okay, but what if it goes a lot higher than that?' We cannot rule that out. If that were to happen, I think it would still be mainly a reflection of what we have been seeing, which is domestic demand in Australia being strong relative to the rest of the world. If that were to happen, would that lead to some disastrous result? I think it may well lead to a reaction, but I suspect the main reaction would be for people to become more wary about holding the Australian dollar and the Australian dollar would then start to go down.[14]

2.9 The CAD for the June quarter was subsequently confirmed as 6.7 percent of GDP; in line with the Governor's prediction, the Australian dollar fell to a three-month low after the announcement (US 63.81 cents at the close of trading on 28 August 2003), before resuming its upwards trend.

World economy

2.10 At the Warrnambool hearing in December 2002, the Governor noted that the international economic outlook had weakened over the second half of the year.[15] The continuing weakness in the world

12 *Official Hansard*, 6 June 2003, Melbourne, p.42.

13 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.2.

14 *Official Hansard*, 6 June 2003, Melbourne, p.58.

15 *Official Hansard*, 6 December 2002, Warrnambool, p.3.

economy remains a concern, as indicated by Mr Macfarlane at the June 2003 hearing:

> A return to firmer growth was expected early in 2003, but observers watching for signs of that quickly found the picture clouded by concerns about the growing likelihood of war in Iraq and then its actual occurrence. The relatively quick resolution of hostilities and the associated drop in the oil price was a major plus for the global economy compared with the possible alternative. Confidence recovered some ground, and attention returned to underlying economic trends, but the incoming data did not give any encouragement.
>
> It is now clear that a pick-up in global growth has not occurred in the first half of 2003. The international forecasting community have now pushed the forecast pick-up back to the second half of the year, though there are few signs in support of this.[16]

2.11 The Governor noted that two pieces of news from the United States had dampened the "short-lived optimism" that followed the end of the Iraq war and the fall in oil prices. The first was statements from the US Federal Reserve which were interpreted as suggesting that deflation was at least a possibility for the US economy, sending US bond yields to 45-year lows. The second was comments by the US Secretary of Treasury which were viewed as signalling that a declining US dollar was in the interests of the US economy. As explained by the Governor:

> …many countries which so far have enjoyed the stimulus of exporting to the United States when the US dollar was high will need to find domestic sources of expansion. There is a great deal of scepticism about how successful the two main areas outside the United States – Japan and the euro area – will be in this endeavour.[17]

2.12 It was in this general context that some overseas central banks reduced interest rates in the few days before the hearing – notably, a reduction of 0.5 percent by the European Central Bank the day before the hearing. The Governor, in explaining why the RBA had not followed suit, drew attention to Australia's stronger domestic

16 *Official Hansard*, 6 June 2003, Melbourne, p.42. See also Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, pp.1-2.

17 *Official Hansard*, 6 June 2003, Melbourne, pp.44-45.

conditions and higher inflation than other countries, noting in particular the virtual absence of growth in the Euro area economy.[18]

2.13 The Governor stated that the "major risk" presently facing the Australian economy is the possibility of continued weakness in the world economy feeding through to our economy through a further weakening of exports.[19] He acknowledged that there had been differing opinions between the RBA and the Treasury (see page 44) on the magnitude of that risk, with Treasury placing "a higher risk of a big surprise on the down side".[20]

2.14 The Committee asked Mr Macfarlane, "If there were a difference of view and a suggestion from Treasury that perhaps rates should be cut by a quarter of a per cent, then – looking at that as a policy move – do you think that would be sending an entirely wrong signal to the property market at the moment?". The Governor responded that:

> It could, yes… there is a risk that that could give another final boost to a credit cycle that was very late in its maturity and was probably almost about to turn down. That would not be very helpful.[21]

2.15 In response to a further question from the Committee about the effect of international events on the direction of interest rates in Australia, Mr Macfarlane indicated that:

> What we really are talking about is whether interest rates stay the same or whether they go down… All the central banks around the world are grappling with that issue, and we are no different to the others in that sense.[22]

2.16 Following the June hearing, however, interest rates remained unchanged until the increase in November 2003, with the RBA citing as reasons for that increase improved conditions in the international and domestic economy and persistent high levels of credit growth (driven largely by housing investment; see page 15). In September 2003 Mr Glenn Stevens, the RBA's Deputy Governor, had commented that while in early June a case to ease interest rates had looked like it was building:

> …it had not strengthened sufficiently by the time of the July [Board] meeting to warrant action. In August the case got

18 *Official Hansard*, 6 June 2003, Melbourne, p.45 and p.47.
19 *Official Hansard*, 6 June 2003, Melbourne, p.45 and p.47.
20 *Official Hansard*, 6 June 2003, Melbourne, p.51.
21 *Official Hansard*, 6 June 2003, Melbourne, p.52.
22 *Official Hansard*, 6 June 2003, Melbourne, pp.46-47.

> weaker, and it got weaker again by early September. Essentially what happened was that the risks to growth from abroad abated, while those posed by the rapid rise in [household] debt did not.[23]

2.17 The Committee's next hearing with the RBA, on 8 December 2003, will provide an opportunity for the RBA to elaborate on the reasons for the November 2003 rate increase and the impact of the improving world economy.

Overview of the domestic economy

2.18 As already noted, economic growth for 2002-03 was 2.75 percent. While a reduction on previous years, the growth figure nonetheless represents 12 consecutive years of expansion for the Australian economy, a remarkable performance by international standards.[24]

2.19 At the Melbourne hearing the Governor offered the following general overview of the economy[25]:

- domestic demand continues to grow at a high rate – while some deceleration from the current rate of approximately 5.5 percent is expected, "the most recent data do not suggest that the deceleration will be large";
- consumption had grown by 3.5 percent over the year to the March quarter with more recent data, such as retail trade, showing good rises in March and April 2003. Prospects for consumption look "quite good", given growth in employment and incomes and consumer confidence above its longer-term average. Private investment is similarly holding up well, with growth for the year likely to be in the order of 10 percent;
- most surveys show above-average results for business conditions and business confidence. The corporate sector as a whole is in "excellent financial health", with conservative gearing, good profitability and ready access to credit (albeit not being utilised to a great extent because of ready access to internal funds). According to the RBA's May 2003 *Statement on Monetary Policy*, the current

23 Address to the Australian Business Economists and the Economic Society of Australia (NSW Branch) quoted in Reserve Bank of Australia, *Bulletin*, October 2003, p.15.

24 See also table in *The Economist*, 24 May 2003, in which Australia's GDP forecasts saw it assessed as having better growth prospects than all other economies surveyed, including 11 European economies, the United States, Japan and Canada.

25 *Official Hansard*, 6 June 2003, Melbourne, pp.42-43.

upswing in business investment appears to have "some way yet to run" – business surveys suggest further expansion in aggregate investment and there is a large volume of work outstanding in a range of resource and infrastructure projects[26]; and

- employment had grown by 2.5 percent over the preceding year, with the unemployment rate of 6.1 percent (as at the June 2003 hearing) being "about as low as it has been in the present expansion".

2.20 The Governor noted that although overall growth had been good, the experience amongst different industries was varied. Large sections of agriculture are still suffering the consequences of the drought, and the tourist and international transportation sectors had suffered a sharp fall in activity associated with the public reaction to the SARS virus, compounding the drop in travel associated with the Iraq war.[27]

2.21 In relation to the state of the domestic economy and monetary policy settings, the Governor concluded that, overall:

> …an examination of the domestic economy leads us to conclude that there is little or no evidence to suggest that monetary policy has been too tight or is currently exerting a restrictive influence on domestic demand. But that is only part of the story, and possibly the smaller part. Policy must also take into account the impact of international forces.[28]

Impact of the drought

2.22 In relation to the economic impact of the drought, the Governor advised the Committee (based on information from the Australian Bureau of Agricultural and Resource Economics, ABARE) that farm production had fallen by approximately 30 percent in 2002-03, taking approximately 1 percent off GDP.[29] With the breaking of the drought, ABARE is forecasting a rebound in agricultural production, adding approximately 0.75 percent to GDP in 2003-04.[30]

26 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.28.

27 *Official Hansard*, 6 June 2003, Melbourne, p.43.

28 *Official Hansard*, 6 June 2003, Melbourne, p.44.

29 The Treasurer similarly noted, upon the release of the June 2003 National Accounts, that "the ABS estimates that the drought reduced agricultural production by 28.5 percent in 2002-03, subtracting 1 percentage point from overall GDP growth". See the Hon Peter Costello MP, "National Accounts: June Quarter 2003" (Media release, 2 September 2003), at *www.treasurer.gov.au/tsr/content/pressreleases/2003/076.asp?pf=1* (as at September 2003).

30 *Official Hansard*, 6 June 2003, Melbourne, p.61.

2.23 The Governor also noted, at the Warrnambool hearing, that the drought had not had the adverse impact on farm debt and capacity to service that debt that might have been expected, based on past experience:

> Farm debt is not actually rocketing up… 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 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.[31]

2.24 The Governor indicated that the RBA did not have the authority to direct commercial banks in relation to lending to the rural sector, and that 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, rather than the RBA, to attempt to influence the banks.[32]

2.25 The Committee's own discussions with the banking sector would suggest that the banks have taken a more prudent, long-term approach than during previous droughts, when in some instances an inflexible attitude did substantial harm to individuals and businesses in the rural sector and to the image of the banks themselves.

Inflation outlook

2.26 The RBA has a formal target range for underlying inflation of between 2 and 3 percent. The inflation outlook is therefore a major determinant of interest rate policy, with implications for mortgage repayments, new business investment, the purchase of consumer durables, and – given the implications for the exchange rate – the well-being of farmers and other exporters.[33]

2.27 At the June 2003 hearing the Governor advised that consumer prices were rising at 3.4 percent per annum and wage costs at about 3.6 percent. Inflation had been close to, or above, 3 percent (the top end of the RBA's target range) for more than a year. According to the Governor:

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31 *Official Hansard*, 6 December 2002, Warrnambool, pp.12-13. See also pp.17-18.

32 *Official Hansard*, 6 December 2002, Warrnambool, p.37.

33 Briefing material prepared by the Parliamentary Research Service.

> This would be a source of concern if we expected the situation to persist long enough to become entrenched in expectations but, as I said earlier, inflation is likely to decline in coming quarters and overall growth in labour costs is consistent with our inflation target. So the inflationary situation is not a cause for concern.[34]

2.28 The Governor's assessment has since been reiterated in the August 2003 *Statement on Monetary Policy*, in which the RBA advised that due to further net appreciation of the Australian dollar, year-ended underlying inflation appears likely to further decline to 2 percent in the first half of 2004.[35]

2.29 The outlook for wage costs – which account for approximately 70 percent of the movement in prices – also suggests a benign inflation outlook. The budget forecast for wage increases in 2003-2004 is just 2.75 percent.[36]

Deflation

2.30 At the Melbourne hearing the Committee asked the Governor whether the Australian economy was at any risk of deflation, given the deflation experienced in some Asian economies and the risk of deflation in some European countries. Mr Macfarlane responded by noting that a recent IMF study had classified the world into four groups, with Australia in the group least likely to suffer from deflation. The RBA's Deputy Governor, Mr Glenn Stevens, added:

> It is true that there are several countries in Asia which are now experiencing, or have recently experienced, falling prices. Taiwan, if they are not there, are close. Hong Kong, of course, has had quite a pronounced deflation. China has had some, though in China at present they are back to a very slight positive inflation rate. Japan, of course, has had declining prices for several years and they, I think, are the clearest case of the bad form of deflation, which is due to chronically weak demand and which arguably feeds back into making demand weak again, so that you get a kind of vicious cycle. Apart from them, one has to say that inflation rates generally in most industrial countries are quite low and they are tending to fall, so it is not at all inconceivable that one or two more countries might find prices declining at some point

34 *Official Hansard*, 6 June 2003, Melbourne, p.43.

35 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2003, p.56.

36 Briefing material prepared by the Parliamentary Research Service.

> briefly during the current downswing… If the question is: is this likely to be a problem which we confront? I think that is quite unlikely. For a start, we are starting with a higher inflation rate than most countries. A lot of things would have to go wrong around the world for us to find ourselves in deflation, so I regard that as a very low likelihood outcome.[37]

Unemployment and monetary policy

2.31 The Committee asked the Governor about the extent to which the unemployment rate is taken into account in determining official interest rates, given that the *Reserve Bank 1959* requires the RBA's Board to conduct monetary policy in a way that will best contribute to factors including "the maintenance of full employment in Australia". Mr Macfarlane responded that the Board interprets that requirement in the Act to mean the provision of sustained economic growth, "which is an absolute necessity for getting any employment growth".[38] He added that employment outcomes are subject to factors over which the RBA has no control, such as minimum wages, hiring and firing conditions and award structures.

2.32 In response to a further query as to whether the RBA should continue to focus heavily on inflation when determining monetary policy settings – given that inflation has been moderate for some time – or whether other factors such as employment should now be given greater prominence, the Governor stated that:

> The reason you have an inflation targeting regime when you do not have an unemployment targeting regime is not because you are not interested in unemployment, not because you think it is unimportant; it is because history has told you that you can achieve a particular inflation rate with monetary policy but you cannot achieve a particular unemployment rate just with monetary policy; it depends on all these other factors. That is why not just Australia but so many other countries have an inflation targeting regime, not an unemployment targeting regime, even though they may be equally or more interested in employment in the long run than in inflation.[39]

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37 *Official Hansard*, 6 June 2003, Melbourne, p.50.

38 *Official Hansard*, 6 June 2003, Melbourne, p.73.

39 *Official Hansard*, 6 June 2003, Melbourne, p.73.

2.33 On a related subject, the Governor was asked for his perspective on the extent to which inflexible unfair dismissal laws affect employment outcomes, based on the European experience:

> Most of Europe has unemployment rates well above ours. There are a few exceptions, but even then you have to look very closely. Some of the countries that have low unemployment rates have an incredible number of people on disability pensions, and if you were to put the two together you might get a fairer assessment… There is some evidence around the world that stringent unfair dismissal rules lead to higher levels of unemployment. This used to be summarised by people who contrasted the huge growth of employment occurring in America with the almost zero growth of employment occurring in Europe and said that the country that fires the most hires the most. That is why it is a big issue in some of these European countries. I think there is recognition that it enormously reduces the flexibility of their economies, and it makes firms very reluctant to hire if that flexibility is taken away from them. Once again, I am not an expert on the subject, but certainly a lot has been written about the capacity for creating jobs in countries with flexible labour forces and the difficulty of creating new jobs in the heavily regulated European economies.[40]

Housing sector

2.34 A major area of concern to the Committee, the RBA and other observers is the sustained growth of household credit – according to the Governor, far higher than in any comparable country – being driven by speculative activity in the investment housing sector. As explained by Mr Macfarlane at the Melbourne hearing:

> Aggregate credit has grown by 13 percent over the past year, which is quite a high figure in an economy where nominal GDP has grown by 6 percent. When we look more closely, we find that household credit has grown by 20 percent and that credit to the household sector for housing purposes has grown by 21 percent. Credit for investors in housing is estimated to be growing at about 28 percent. Thus, we have a situation where credit is growing a good deal faster than

40 *Official Hansard*, 6 June 2003, Melbourne, p.74.

> appears necessary to satisfy the needs of the economy. This situation is wholly due to credit being channelled into the housing sector. When we see figures of this order of magnitude it is hard not to conclude that a significant part of this must be directed to speculative purposes.[41]

2.35 At the Warrnambool hearing the Governor had similarly noted that a disproportionate amount of the upwards pressure on property prices was coming from investors in apartments. He expressed the fear that many of these highly-leveraged investors "are just assuming that things will work out".[42] Mr Macfarlane took the opportunity to remind investors that they are making a commercial property decision, and drew attention to excesses in the commercial property market in the 1980s and the large price falls that followed.

2.36 At the Melbourne hearing the Governor warned that the rapid growth of household credit is presently the main domestic risk to the Australian economy.[43] He raised a worst-case scenario where the household sector "continue[s] putting itself into a more exposed position at the rate it has over the past few years"[44] at the same time as a sustained weakening of the world economy:

> …if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing – the credit driven house price spiral – also continues over that 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession… I do not think that is going to happen because I can see the speculative excesses starting to abate. At the moment, the jury is still out on the world economy. It is going ahead at an unsatisfactorily low rate, but it is still growth. It is not as though it is in recession. But if that were to happen – if it were to go into recession and the speculative excesses of the housing market were to continue – then there would be a huge amount of distress at the end.[45]

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41 *Official Hansard*, 6 June 2003, Melbourne, p.44.
42 *Official Hansard*, 6 December 2002, Warrnambool, p.5.
43 *Official Hansard*, 6 June 2003, Melbourne, p.45.
44 *Official Hansard*, 6 June 2003, Melbourne, p.46.
45 *Official Hansard*, 6 June 2003, Melbourne, p.53.

2.37 The Governor noted that 40 percent of people in Australia own their homes outright, while another 30 percent are renters. Of the 30 percent who have mortgages, "probably more than half" have a long-term mortgage that has run down. The issue arises with the increasing proportion of mortgage-holders who are at the vulnerable stage of holding the largest mortgage they can afford:

> There is always a proportion in that situation: the newcomers to the market.
>
> What is happening now is [that] more and more people are permanently staying in that vulnerable state. They go out and use the equity of their home to buy another property or something else, so they keep themselves at the vulnerable end. So, instead of only a small proportion of the population being at that vulnerable stage of life, there is now a much larger proportion of the population. I do not know what the numbers are – they are probably very small. Maybe it used to be 1 percent; maybe now it is 5 or 6 percent.[46]

2.38 The Governor had previously noted that while there is nothing new about middle and upper-income households in Australia seeking to purchase investment property, there have been two substantial changes since the 1970s and 1980s. The first change relates to bank lending practices. Whereas banks used to charge a penalty interest rate for investment housing loans, and demand a deposit up front, in the 1990s those constraints disappeared. Many more people are now able to access the investment housing market, to the extent of being able to make these major financial decisions "almost impulsively":

> …banks are actually advertising for you to come and borrow from them for this purpose [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.[47]

46 *Official Hansard*, 6 June 2003, Melbourne, p.56.

47 *Official Hansard*, 6 December 2002, Warrnambool, p.14 and p.16.

2.39 The second major change is that nearly all the apartment projects in the current cycle have been pre-sold, meaning that a large proportion of the risk has been transferred from property developers to investors. Many of those investors may not be able to handle that risk in the event that they are unable to find tenants, or if they wish to sell in a secondary market where prices are much lower than the prices at which developers have pre-sold the apartments.[48]

2.40 The Committee asked the Governor whether he would like to see another financial tool – other than interest rates – available to contain the housing sector.[49] Mr Macfarlane responded that:

> We have another financial tool. It is called open-mouth policy, and I have been using it, but it may not be as effective as other tools you could conceive of. I am not putting in a plug for another instrument, although if in the longer run things turned out badly it would not surprise me if people started looking at other arms of policy – for example, tax policy. We have a tax regime in Australia which, compared to a number of other countries, is very favourable to property speculation. I am not saying 'Change it', but I would not rule out the possibility that if things do turn out badly there may be a public desire to make some changes.[50]

2.41 It is interesting to note, in light of the then market speculation about an imminent rise in interest rates, that at the Melbourne hearing the Governor rejected the view that this is the only means through which housing activity might be slowed down. While housing booms in the past have come to an end when interest rates have increased, usually a recession has occurred at the same time. In 1985 interest rates increased to 18 percent, but there was no recession and "very little effect" on the housing industry.[51]

2.42 The Committee asked the Governor whether he had spoken to the major banks about their lending practices. Mr Macfarlane, noting in passing that under the old regulatory system the RBA was able to impose a direct limit on how much banks could lend, indicated that while he had spoken to some CEOs, the body that has responsibility for the soundness of lending practices is the Australian Prudential Regulation Authority (APRA).[52]

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48 *Official Hansard*, 6 December 2002, Warrnambool, p.15. See also p.33.

49 See also *Official Hansard*, 6 December 2002, Warrnambool, pp.32-33.

50 *Official Hansard*, 6 June 2003, Melbourne, p.55.

51 *Official Hansard*, 6 June 2003, Melbourne, pp.48-49.

52 *Official Hansard*, 6 June 2003, Melbourne, p.55.

2.43 APRA has subsequently released the results of a "stress test" indicating that 90 percent of Australia's 120 regulated financial institutions, including the main home loan providers, could withstand a 30 percent slump in house prices over one year (it should be noted that an increasing number of mortgage originators are not regulated by APRA). Under such a scenario defaults on mortgages would increase from the current 0.12 percent to approximately 3.5 percent; however, losses incurred by the institutions would be less than 1 percent, with most of this covered by mortgage insurance.[53]

2.44 The banking sector would therefore appear to be in a position to withstand a sudden decline in the value of housing but, as the Governor noted, the capacity of individual households to withstand similar pressures is a different matter. APRA cautioned that borrowers are most vulnerable early in the life of a loan, as they have generally not built up substantial equity in their property, and noted that of the loans it surveyed, 42 percent were less than a year old and 77 percent were less than three years old.[54]

2.45 Also on the regulatory front, the Governor noted that the Australian Securities and Investments Commission (ASIC), which is responsible for investor protection, had attempted to limit the widespread growth of "investment seminars":

> …where people come along and get told how to get rich quickly by using the equity in their existing home to gear up and buy a couple more apartments. ASIC would love to stop that. The problem is they cannot demonstrate that these people are in fact financial advisers. If they were, they would have control over them. But the people who run the investment seminars say, 'No, we're not. We are humble real estate agents and we're not subject to your laws—we're subject to state laws'
>
> …I think there is a regulatory gap there. It is clearly a problem if there is one group of people who are holding seminars on how to invest your money who are regulated – the financial planners – and there is another group who are doing almost exactly the same thing, although doing it within the one asset class, which is property, who are unregulated.

53 See "Banks Pass the Housing Crash Test", *Australian Financial Review*, 10 October 2003, p.1, and "Bank Regulator Warns of Loans Risk", *The Australian,* 10 October 2003, p.2.

54 See "Bank Regulator Warns of Loans Risk", *The Australian,* 10 October 2003, p.2.

> So I think there is a need to extend the capacity for ASIC to do that.[55]

2.46 The Committee welcomes recent indications that both ASIC and the Australian Competition and Consumer Commission (ACCC) are endeavouring to curb the practices described by the Governor.[56] The Committee will continue to pursue this issue with all relevant agencies to ensure that the practices described by Mr Macfarlane are properly scrutinised – the Annual Reports of ASIC and the ACCC, like that of the RBA, stand referred to this Committee.

2.47 The RBA's May 2003 *Statement on Monetary Policy* cautiously asserted that forward indicators of building activity have been pointing to a "fairly gradual" downturn for some time, with activity underpinned by a backlog of unfinished work and strong demand for renovations.[57] At the June public hearing the Governor similarly suggested that there are some early signs that "a degree of commonsense" is returning in the most speculative hot spots in the real estate market:

> Investor interest in inner city apartments, particularly in [Melbourne], is well down and quite a number of proposed projects have been shelved. In addition, estimates of future vacancy rates are being revised upwards and rents are falling. If this interpretation is correct, it should in time be reflected in the normal statistical collections on credit and prices. But these statistics inevitably contain quite long lags, so they will be the last indicators to turn down.[58]

2.48 On this last point, in response to questions from the Committee the Governor cautioned that it would be a "policy mistake" for the RBA to wait for irrefutable proof that the speculative element has gone out of the housing market before taking any corrective action it deemed necessary.[59]

2.49 While there may be some early signs that the housing market is softening, the Committee notes that previous assessments that activity in the sector has peaked have proved to be premature. Australian Bureau of Statistics data indicate that borrowing for investment properties increased to a record $6.81 billion in August 2003, 5 percent

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55 *Official Hansard*, 6 June 2003, Melbourne, p.55 and p.59.

56 For example, recent action against Mr Henry Kaye's National Investments Institute launched by both the ACCC and ASIC.

57 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.3.

58 *Official Hansard*, 6 June 2003, Melbourne, p.45.

59 *Official Hansard*, 6 June 2003, Melbourne, p.48.

higher than the previous month and a 35 percent increase since August 2002.[60] The RBA has indicated that housing credit increased by 21.5 percent in the year to July 2003, while in the June quarter household debt grew by $32 billion – the largest quarterly rise on record – to a record $632 billion, again due mainly to continued increases in housing lending.

2.50 The RBA's August 2003 *Statement on Monetary Policy*, while again suggesting that activity in the housing sector has peaked, also noted that:

> Apart from inner Melbourne where apartment prices are falling, there are few signs yet of these pressures easing off. The latest indicators of housing prices continue to show strong growth in most areas, and new finance approvals for housing have been accelerating in the past few months.
>
> The risk presented by these developments is that, the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn. Banks report that they are taking a prudent approach to lending for housing [but] increasingly there are signs of worrying practices elsewhere in the financial system. This is not untypical of a prolonged bull market, and could cause a great deal of distress to the economy when the housing price cycle turns.[61]

2.51 The *Statement on Monetary Policy* noted that 7.6 percent of household disposable income is now servicing housing loans, a ratio approaching that of the late 1980s when mortgage rates were as high as 17 percent. A sudden correction in the property market would have severe consequences for over-extended households and for the wider economy. The veracity of the Governor's assessment in Melbourne that "a degree of commonsense" is returning to the housing market will be a major focus of the Committee's public hearings for the RBA's *Annual Report 2003.*

Regional Australia

2.52 At the Melbourne hearing the Committee questioned the Governor on whether speculative real estate transactions pose an even greater relative risk in regional Australia. In many regional areas there has been a rapid rise in land values and property prices, due in large part to city dwellers taking advantage of increases in their property values

60 "Property Investment Loans Hit New High", *The Australian Financial Review*, 14 October 2003, p.4.

61 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2003, p.3.

to sell up and move to regional areas. The Governor responded that he did not think there was a serious financial risk involved:

> There is nowhere near as much risk in an owner-occupier buying a house to live in, because there is very little speculative element in that. The part that becomes risky is when someone signs up to pay for something that is going to be completed in 18 months time, and then at that point they hope to rent it out to someone else whom they do not know for a rent they do not know. That is where the really speculative element comes in. But if someone in the city whose house has gone up in value decides that they would prefer a different lifestyle and they sell their house in the city and move to the country, I do not find that in any way worrying. In fact, it is probably a very satisfactory development for Australia.[62]

Exchange rate

2.53 A rapid appreciation of the Australian dollar against the US dollar (due principally to a weakening US$) generated considerable public debate in the lead-up to the Melbourne hearing. In the last quarter of 2001 the dollar was valued at under US 50c. As can be seen in the graph below, which displays movements in the A$ against both the US dollar and the trade-weighted index, prior to the June 2003 hearing the exchange rate passed through the US 66c barrier, representing an increase of some 40 percent since late 2001.

62 *Official Hansard*, 6 June 2003, Melbourne, p.53.

2.54 At the time of the hearing there was concern about tension between monetary policy settings directed at speculative investment in the housing sector, and a perceived need for a rate reduction to moderate the rapid appreciation of the dollar to the benefit of Australian exporters.

2.55 In response to a direct question from the Committee as to which posed the greater risk to the economy – a large adjustment in house prices, or a further appreciation in the exchange rate with a negative impact on exports – the Governor responded:

> …depends on the orders of magnitude. Clearly, if the appreciation were big enough and it were hurting enough, that would be a much bigger factor than if the housing thing went up just a little bit more. It is all a function of the orders of magnitude. That is why the assessment changes every month as you get more information coming in.[63]

2.56 Members of the Committee expressed concern about the rapid rise in the Australian dollar and noted that financial markets appeared to have been surprised by the currency movements, with profit downgrades for many blue-chip companies prior to the hearing. Notwithstanding that the official interest rate of 4.75 percent had at that time remained unchanged since June 2002, the Governor rejected suggestions that monetary policy was too tight or that the RBA had been "asleep at the wheel":

> I want to reassure you that it is not as though we do nothing, not worry about [the exchange rate] until an alarm bell rings when it hits a critical level and then start thinking about it. The exchange rate is continuously feeding into the monetary policy decision. Every time you make a forecast of what you think economic activity or inflation is going to do, one of the important variables is the exchange rate. If the exchange rate has gone up between point of time A and point of time B then, other things being equal, your forecast for inflation will go down and your forecast for economic activity will go down, and that will influence your decision on monetary policy. It is continuously having an influence on our decision on monetary policy; it is not as though we have to wait for a particular level to be breached for us to start taking an interest in it.[64]

63 *Official Hansard*, 6 June 2003, Melbourne, p.51.

64 *Official Hansard*, 6 June 2003, Melbourne, p.49.

2.57 While the Governor acknowledged that risks would arise if the Australian dollar continued to appreciate at the rate experienced in May 2003, he rejected claims that the appreciation of the dollar in the lead-up to the Melbourne hearing could be labelled excessive. Mr Macfarlane pointed out that the trade weighted exchange rate had returned to roughly its post-float average, while the rate against the US dollar was, at that time, still well below the post-float average.[65]

2.58 While the rate of increase in the exchange rate has slowed since the hearing, the Committee notes that in October 2003 the A$ traded above US70c for the first time in six years, with concern being expressed by some exporters about the impact on their competitiveness[66], particularly given market speculation at that time that the next movement in interest rates would be an increase.

2.59 On a related subject, at the June hearing Committee members noted that the Current Account Deficit had performed similarly in 1997, around the time of the Asian economic crisis, but without the rapid appreciation of the dollar experienced in mid-2003. Committee members asked whether the dollar's appreciation needed to be curbed through monetary policy adjustments to cushion the economy against the growth in the CAD. The increase in the A$ appeared to be inconsistent with Australia's recent subdued trade performance, with past experience (notably during the Asian economic crisis) suggesting that the A$ should decline at times when there is concern about Australia's ability to export into a more sluggish world economy. Further, following the Asian economic crisis the RBA reduced official interest rates and for most of the period afterwards kept them at or below US official interest rates.[67] However, at the time of the Melbourne hearing the US federal funds rate was just 1.25 percent, compared with Australia's cash rate of 4.75 percent.

2.60 The Governor, while indicating that the differentials in monetary policy settings between Australia and the rest of the world (particularly the United States) were taken into account by the RBA, responded that:

> During the Asian crisis we did nothing. That was our great success: to do nothing. Everyone else tightened and we did not. We did not actually loosen, we just did not tighten, and

65 *Official Hansard*, 6 June 2003, Melbourne, p.45. See also p.57.

66 See for example "Strong Aussie – What a Drag", *The Age*, 10 October 2003. Some 25 percent of manufacturers recently surveyed by the Australian Industry Group cited an exchange rate of US70c as a trigger point for financial stress.

67 Briefing material prepared by the Parliamentary Research Service.

> we got through the Asian crisis very well. It is true the currency did weaken, but it did not weaken anywhere near as much as it subsequently weakened in 2000-01. So it turns out that our currency was more affected by the fashions of financial markets during the new economy age than it was by this very profound event: the Asian crisis. We actually entered this current phase of world weakness with an exceptionally low currency, as you know. The recession year was 2001, and in May 2001 we had an Australian dollar at 47c. So we entered this thing with an exceptionally low exchange rate, which is one of the reasons why it has gone up—the starting point was just so low.[68]

Impact of budget deficits on monetary policy

2.61 At the Warrnambool hearing the Committee questioned the Governor about the impact of budget deficits on the conduct of monetary policy. Mr Macfarlane indicated that the size of deficits or surpluses, at either the State or federal level, was for the most part no longer 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.[69]

68 *Official Hansard*, 6 June 2003, Melbourne, p.60.
69 *Official Hansard*, 6 December 2002, Warrnambool, p.36.

Forward outlook for the Australian economy and monetary policy

2.62 The Governor suggested four possible scenarios for the Australian economy and monetary policy settings, based on the international and domestic risks he presented at the Melbourne hearing:

- a weakening world outlook together with a weakening domestic outlook (entailing an easing of domestic and asset market pressures) would provide a "reasonably clear prognosis" for monetary policy – that is to say, interest rate reductions;
- in the other direction, a combination of a clear strengthening of the world economy, and continued domestic buoyancy, would similarly "be easy" in terms of decisions about monetary policy – as subsequently was reflected in the reasoning for the November 2003 rate increase;[70]
- the most favourable outcome for Australia would be firming world economy and an easing in domestic pressures, resulting in "more balanced" economic growth;
- however, as mentioned at page 16 the combination that would be most damaging for the Australian economy would be if the household sector were to continue putting itself into a more exposed position while, at the same time, a further weakening of the world economy was starting to feed through to the Australian economy.[71]

2.63 In its May 2003 *Statement on Monetary Policy* the RBA expressed confidence that the prospects are for "a more balanced composition of growth" to emerge (ie, the third of the Governor's scenarios above), with less reliance on domestic demand and a smaller drag from the external sector.[72] The Committee will seek an update on this forecast at its next public hearing with the RBA, to be held in Brisbane on 8 December 2003.

70 See "Statement by the Governor, Mr Ian Macfarlane: Monetary Policy", 5 November 2003 at www.rba.gov.au / MediaReleases / mr_03_15.html (as at November 2003).

71 *Official Hansard*, 6 June 2003, Melbourne, pp.45-46 and p.52.

72 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.3.

3

Other matters

Bank fees

3.1 The RBA, at the instigation of this Committee, collects statistics on bank fees (although responsibility for consumer protection, in the event that an individual bank's fees were considered inappropriate, would be a matter for the ACCC).[73]

3.2 Since 1997 the RBA has undertaken an annual survey of fees earned by banks' Australian operations. The results of the 2002 survey were published in the April 2003 edition of the RBA's *Bulletin*. The main findings of the survey were that:

- growth in fee income from deposits, loans and transaction services was 10 percent, the smallest rise since 1997. This growth rate was a little below that in banks' domestic assets;
- the major contributors to growth in fee income have been the rapid growth in housing finance and credit card spending; and
- the increase in banks' fee income has offset only a small part of the reduction in banks' interest rate margins over the past decade.[74]

3.3 Notwithstanding this last point, fees charged to households have increased from $1.2 billion in 1997 to $2.7 billion in 2002. Fee income from households accounted for 35 percent of banks' total fee income (households plus businesses) in 2002, compared to 30 percent in 1997.

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73 *Official Hansard*, 6 June 2003, Melbourne, pp.24-25.

74 Reserve Bank of Australia, "Banking Fees in Australia", *Bulletin*, April 2003.

3.4 The Committee asked the RBA whether these figures reflect a capacity on the part of the banks to recoup reductions in business loan margins from the household sector, and whether this in turn indicates that the banks are not facing proper competitive pressure to keep fees down.

3.5 The RBA's Assistant Governor (Financial Markets), Mr Ric Battellino, advised that while total income from fees on households has risen faster than income from fees on businesses, this is due to a substantial increase in the volume of household transactions with banks, in particular housing loans and credit card transactions. The fees charged per transaction, particularly in the case of housing loans, have fallen in the 1997-2002 period. In the case of housing loans, the reduction in fees per transaction can be attributed to the entry of non-bank competitors.[75]

3.6 However, recent reports suggest that this issue may need to be revisited, at least in relation to credit card fees. Analysis by BIS Shrapnel suggests that fee rises, together with increases in the loyalty points needed to redeem rewards, have led to increases in the cost of holding a credit card of between 35 and 75 percent, offsetting the expected loss in revenues rising from reductions in credit card interchange fees (see page 35).[76] The Committee will continue to pursue this issue in discussions with the banking sector, the RBA and other regulatory agencies.

Interchange fees

3.7 "Interchange" fees are paid between financial institutions of persons receiving payments and persons making payments in the four party credit card systems (Bankcard, MasterCard and Visa), the EFTPOS system, ATM networks and in BPay.

3.8 In a joint study with the ACCC in 1999-2000, the RBA examined the economic case for interchange fees in ATMs, EFTPOS and credit card services. These systems were chosen because they account for a very large proportion of retail payments in Australia and all have interchange fees. After analysing detailed data on costs and revenues,

75 *Official Hansard*, 6 June 2003, Melbourne, p.62. See also *Official Hansard*, 6 December 2002, Warrnambool, pp.24-27.

76 "Banks Pass Credit Card Costs on to Consumers", *The Australian Financial Review*, 1 November 2003, p.8.

the RBA concluded that there was no justification for an interchange fee in the EFTPOS system.[77]

3.9 The Governor noted at the Melbourne hearing that the banks had put to the ACCC a proposal to abolish wholesale EFTPOS interchange fees. Mr Macfarlane referred to this proposal as “a very constructive step”, and expressed hope that the “elaborate procedures” that the RBA had been through in relation to credit card reform (see page 33), involving formal designation of payment streams, could be avoided.[78]

3.10 However, in August 2003 the ACCC rejected the banks’ proposal, stating that:

> The ACCC is concerned that the EFTPOS proposal addresses only one element of reform in this area – that is, the setting of wholesale fees. Without reforming access to the network and making it easier for new groups to enter and compete, consumers and small business may be disadvantaged by the proposal…
>
> The ACCC is concerned that the proposed agreement is likely to increase the barriers faced by new entrants seeking to compete against the banks and other financial institutions in the EFTPOS network. It may also act to further entrench the already high level of concentration in the EFTPOS network (currently the four major banks issue about 70% of debit cards and provide about 85% of merchant services)…
>
> The ACCC considers that a proposal that included reform of access that would increase competition between banks in the EFTPOS network would be more likely to be in the public interest.[79]

3.11 The RBA has subsequently stated that it “encourages the industry to take up the ACCC’s invitation to also address access to the EFTPOS network”.[80] Further progress on reform of interchange fees will be closely monitored by the Committee in future discussions with both the RBA and the ACCC.

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77 RBA, Submission No.3 (answer to question taken on notice at the 6 June 2003 public hearing) at *www.aph.gov.au/house/committee/efpa/rba2001-02/RBAresponse.pdf* (as at September 2003).

78 *Official Hansard*, 6 June 2003, Melbourne, p.64.

79 ACCC, “ACCC Proposes to Deny EFTPOS Price-Fix” (media release, 8 August 2003) at *http://203.6.251.7/accc.internet/digest/view_media.cfm?RecordID=1088* (as at September 2003).

80 Reserve Bank of Australia, *Annual Report 2003*, p.19.

Interchange fees: BPay

3.12 One particular interchange fee of interest to the Committee is that applied to payments made through BPay. BPay is a bill payment system owned by a group of Australian banks including the four major banks. It began operation in 1997. About 10 million transactions are made through the system each month (compared with total non-cash retail payments of about 350 million a month). BPay allows consumers to pay billers using the telephone or the Internet by accessing funds in either their savings account or credit card account.[81]

3.13 The Committee is concerned that the interchange fee of 59 cents on BPay payments from savings accounts seems to have evaded serious scrutiny. BPay was not included in the joint RBA / ACCC study of interchange fees "as it had only been operational for a couple of years and accounted for a very small number of transactions".[82] While the ACCC examined BPay last year, it made the legal judgement that the current arrangements:

> …do not breach the [Trade Practices] Act because these arrangements do not have the effect of controlling or maintaining the fees charged by banks to billers for BPay services.[83]

3.14 The RBA provided the following response to a question about BPay taken on notice at the June public hearing:

> Even though they both originate payments from savings accounts, EFTPOS and BPay payments are very different and conclusions about costs and revenues from one system may not apply to the other… BPay is a system built for bill payments by phone or using the Internet in which both customers and billers pre-register information. By contrast, the EFTPOS system was primarily designed for transactions at the point of sale… When used for bill payments, the EFTPOS payment is done "over the counter" either directly at the institution doing the billing or more commonly at an agency appointed by the billing institution such as a post office. The EFTPOS system cannot currently be used to make payments over the telephone or Internet.

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81 RBA, Submission No.3.

82 RBA, Submission No.3.

83 "ACCC Concludes Investigation into BPay Scheme" (media release, 21 February 2003) at *http://203.6.251.7/accc.internet/media/search/view_media.cfm?RecordID=960* (as at September 2003).

> With the two processes being so different, we would not necessarily expect institutions' costs and revenues to be the same and thus the case for interchange arrangements to be the same…
>
> As it does with all aspects of the payments system, the Bank will continue to monitor BPay to see whether further detailed study is required.[84]

3.15 The Committee is concerned by the apparently high level of the BPay interchange fee. The Committee is of the view that the RBA should undertake an immediate review with the objective of ensuring that BPay interchange fees are reduced to a reasonable level.

ATM interchange fees

3.16 An overhaul of ATM interchange fees is the "third plank" in the RBA's reform agenda for card payment networks (following proposed reforms to EFTPOS and credit cards). ATM interchange fees arise when cardholders of one institution use an ATM owned by another institution. The fees are paid by the card issuer to the ATM owner, and are determined by bilateral negotiation.[85]

3.17 This Committee's predecessor recommended in June 2001 that the RBA give the same priority to "…ATMs and EFTPOS fees, including loyalty programs, as it gives to credit card fees".[86]

3.18 The joint RBA / ACCC study referred to at page 28 found that cardholders using another institution's ATM are liable for fees that are considerably more than the cost of providing the service, and that competitive forces are not working to bring ATM fees more into line with costs. As explained by the RBA's Payment Systems Board[87]:

> The interchange fee arrangements effectively prevent ATM owners from competing on the basis of price or services provided, since they do not receive any more or less revenue from users for changes in the quality of service or the cost of providing it. The study considered an alternative pricing regime – that of "direct charging" – that would encourage

84 RBA, Submission No.3.

85 Payment Systems Board, *Annual Report 2002,* p.17.

86 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of Reserve Bank Australia Annual Report 1999-2000,* June 2001, p.32.

87 The Payment Systems Board has a mandate to promote safety, efficiency and competition in the payments system in Australia and, since 2001, to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets.

> competition and greater transparency in the pricing of ATM services. Under this regime, there would be a direct relationship between the ATM owner and cardholders wishing to withdraw cash. The ATM owner would charge customers of other financial institutions a transaction fee which would be clearly be posted at each ATM.
>
> …a direct charging regime will result in lower and more transparent fees on "foreign" ATM transactions and, over time, an expansion in the quality and the range of ATM services available to consumers.[88]

3.19 Following consultation with the banking industry, and a proposal from the banks themselves for a direct charging regime, the Payment Systems Board indicated in its 2002 *Annual Report* that it "sees no compelling reason why the industry could not finalise the proposed reform in 2003".[89]

3.20 As at September 2003 the proposed reforms have yet to be finalised. The Committee will pursue this matter, and other aspects of card fees generally, in its hearings for the RBA's *Annual Report 2003*.

Credit card reform

3.21 During 2002 the RBA's Payment Systems Board finalised reforms to credit card schemes in Australia. As explained in the Board's 2002 *Annual Report*:

> The Board has, since its establishment, expressed concern about the structure of price incentives in the card payment market in Australia, which clearly favour the use of credit cards over debit cards. Credit card users are effectively "subsidised", in the sense that they are charged less than the cost of the credit card payment services they use (or are even offered rebates in the form of loyalty points). Banks and other deposit-taking institutions promote the credit card most actively because it is the payment service for which they receive the highest return, even though it is one of the most expensive for merchants to accept. The Board's concern about this structure of price incentives is that it is not the result of normal competitive processes. Rather, it is the consequence of the restrictions imposed by the credit card

88 Payment Systems Board, *Annual Report 2002,* pp.17-18.

89 Payment Systems Board, *Annual Report 2002,* p.18.

> schemes and their members and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee structures for credit cards and the other main payments systems in Australia.
>
> …The pricing of credit card services, in which interchange fees and restrictions on merchant pricing play an integral role, is sending consumers a quite misleading signal about the cost to the community of different payment methods, while barriers to entry are quarantining the credit card schemes from competitive pressures. Overall, the community is paying a higher cost for its retail payments system than is necessary.[90]

3.22 The RBA / ACCC joint study of interchange fees found that in 1999 the average fee per transaction received by card issuers was 0.95 percent. Merchant service fees averaged 1.78 percent of the value of each transaction.

3.23 The study also found that both card issuing and acquiring are very profitable. In the case of card issuing, costs averaged $1.93 per transaction but total revenues averaged $2.69, a mark-up over costs of 39 percent. In the case of credit card acquiring, costs averaged 43c but fee revenues averaged 72c, a mark-up of around 67 percent.[91]

3.24 In April 2001 the RBA designated the Bankcard, MasterCard and Visa “four party” credit card schemes in Australia as payments systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. “Four party” schemes involve four parties in the payment process: the cardholder, the issuer, the acquirer and the merchant. These schemes differ from “three party” schemes (notably American Express and Diners Club) where the accounts of the card issuer and the acquirer are the same.

3.25 The four party schemes all provide for the payment of an interchange fee by the acquirer to the card issuer. The acquirer passes on this cost to the merchant as part of the merchant service fee. The interchange fee is a percentage of the value of the transaction, and is designed to encourage the issuance of credit cards by creating a revenue stream for issuers.[92]

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90 Payment Systems Board, *Annual Report 2002*, p.13.

91 See RBA and ACCC, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees*, 2000, Chapter 5.

92 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, pp.15-16.

3.26 In relation to the formal designation of the credit card schemes, at the Melbourne public hearing the Governor noted that:

> The quickest solution – the lighter touch solution – is actually to go through the ACCC. That is how, if you remember, the credit card reform started. But then it got bogged down when it became clear to us that the authorisation procedures of the ACCC were going to be very time consuming. The ACCC cannot say, 'You are doing it this way; you have to stop doing it that way; you now have to do it this way under authorisation.' All they can do is say, 'What you are doing at the moment is not in the public interest. Go away and come back with another proposal which we may then decide is in the public interest.' That procedure depended very much on the cooperation of the institutions involved and they were not giving it on credit cards [unlike EFTPOS], so both we and the ACCC decided it was much more effective to go down this so-called designation path.[93]

3.27 The RBA announced at the time that it would proceed to establish, in the public interest, a standard for the setting of interchange fees and, if necessary, a standard for merchant pricing of credit card purchases, as well as a regime for access to these credit card schemes.[94] In August 2002 the RBA announced its reforms.[95] These involved:

- a standard on interchange fees that involves an "objective, transparent and cost-based" benchmark against which interchange fees in the three designated credit card schemes can be assessed;
- a standard on merchant pricing that removes the restriction imposed by the international credit card schemes on merchants passing through to cardholders the cost of credit cards; and
- an access regime that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in the designated credit card schemes.

93 *Official Hansard*, 6 June 2003, Melbourne, p.64.

94 Payment Systems Board, *Annual Report 2002,* p.13.

95 For further detail on the preceding consultation process, see House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002, pp.15-19.

3.28 The RBA claimed that the reforms will give a boost to competition in the sector, and cited the experience of the residential mortgage market in asserting that the arrival or the threat of new entrants will put pressure on credit card issuers to keep fees to cardholders down.[96]

3.29 Bankcard, MasterCard and Visa opposed each of the RBA's proposed reforms during the early consultation process, claiming them to be unnecessary and not in the public interest.[97] In September 2002, MasterCard and Visa filed applications in the Federal Court to have the reforms overturned, for reasons including that the RBA had allegedly exceeded its powers under the Payment System (Regulation) Act. The applications were rejected in September 2003. MasterCard has subsequently lodged an appeal to the Full Bench of the Federal Court, and taken separate court action in relation to the RBA rejecting its calculation of a cost-based fee level for MasterCard's member banks.[98]

3.30 Banking industry sources have been quoted as suggesting that when the relevant reforms take effect from 1 November 2003, interchange fees on credit card transactions will fall to a weighted average of approximately 51c per $100 transaction, from about 95c now.[99] The RBA has indicated that it will monitor whether the banks pass on the estimated $400 million in annual savings expected to flow from the wholesale credit card fee reductions. At its next hearing with the RBA the Committee will ask the Governor for an update on the RBA's monitoring role and anticipated progress with the reforms.

3.31 In relation to credit card fees and interest charges to consumers, at the Melbourne hearing the Committee asked the RBA whether the ACCC should be given a reference to examine bank fees and charges overall. Committee members also expressed concern at the social impact of households and consumers being encouraged to use credit cards as their primary form of payment, and asked whether there should be some regulation in this regard.

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96 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, p.36.

97 Payment Systems Board, *Annual Report 2002*, p.14.

98 See "MasterCard Battles RBA Over Fees", *Australian Financial Review*, 23 October 2003, p.17. Visa lodged a similar appeal to that of MasterCard but withdrew the appeal on 29 October 2003.

99 "Customers May Pay For Losses From Card Reforms", *Australian Financial Review*, 10 October 2003, p.62.

3.32 In response, the Governor made the following comments about credit card reform and regulation of bank fees generally:

> The thing about the regulation of credit cards was that we did not seek to regulate any fee a bank charges its customer. We rely on the market to put some discipline there. You can argue one way or another whether there is enough discipline. The only fee we were involved in was a fee which was not set in the marketplace but which was set collectively by providers of the product [the interchange fee]. That was not a market set fee. It was not a market price. It was determined collectively.
>
> On your second issue of why so many payments are being made with credit cards, some of that is starting to change, partly because merchants now have more freedom to accept or reject a credit card. More particularly, they have the freedom to pass on the costs that they got hit with from the bank to the customer and therefore give the customer the option of using a more efficient and cheaper form of payment than the credit card. We are starting to see some signs of that coming through – not on a big scale, but we have seen signs of that happening. That was one of the purposes of the reform of credit cards – to give the merchants back some of the power that had been taken away from them.[100]

3.33 In response to further questioning from the Committee as to why there has not been an overall review of debit cards, ATMs, credit cards and BPay, instead of “ad hoc little inquiries” into each, the Governor stated:

> The reason is that we thought – and we still do – we could get the sorts of reforms that the community needs voluntarily on EFTPOS and on ATMs. But we clearly were not going to get that on credit cards. Credit cards are a much more difficult issue. You can see that by the fact that we are now involved in a very long court case with Visa and MasterCard, who play either no role or only the tiniest role in the EFTPOS or the ATM issue. The credit card issue is going to be a much bigger issue to crack than the other two.[101]

100 *Official Hansard*, 6 June 2003, Melbourne, p.63.

101 *Official Hansard*, 6 June 2003, Melbourne, p.64.

3.34 The Committee remains of the view that an integrated inquiry into the payments system may be beneficial. Such an inquiry could assess how Australia measures up in international terms in moving to more efficient payment methods such as direct-debit[102], and would also provide an opportunity to clarify regulatory responsibilities, given that the ACCC and ASIC, rather than the RBA, are responsible for competition matters and consumer protection.

Credit card fraud

3.35 At the Warrnambool hearing the Committee questioned the Governor on the increasing practice of credit card "skimming", whereby the details contained on a credit card are fraudulently stored after swiping, and the extent to which banks could be forced to update their systems. The Governor responded that:

> 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 [fraud] 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.[103]

3.36 The Reserve Bank's then Assistant Governor (Financial System), Dr John Laker, noted that while the global credit card industry is moving to a more secure "chip and PIN" system, the roll-out will take several years.[104]

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102 For background, see Reserve Bank of Australia, "The Changing Australian Retail Payments Landscape", *Bulletin*, July 2003, pp.1-9.

103 *Official Hansard*, 6 December 2002, Warrnambool, pp.27-28.

104 *Official Hansard*, 6 December 2002, Warrnambool, p.28.

Prudential regulation

3.37 A major topic of public debate at the time of the release of the RBA's *Annual Report 2002* was the adequacy of prudential regulation by, in particular, the Australian Prudential Regulation Authority (APRA) in the wake of the collapse of the HIH insurance group.

3.38 APRA was established on 1 July 1998 as a result of the March 1997 report of the Financial System Inquiry (the Wallis report). The Wallis report had recommended that an integrated regulator be created for the prudential supervision of all financial institutions, including banks, building societies, credit unions, superannuation funds, friendly societies, life insurers and general insurers. APRA was created through a merger of the former Insurance and Superannuation Commission (ISC) and that part of the RBA that had previously undertaken financial supervision of the banking industry.

3.39 APRA was established with a Board including two representatives of the RBA. The Wallis report had stated that substantial board cross-representation on the part of the regulatory agencies would encourage co-operation and foster a common perspective about the financial system.[105]

3.40 The report of the Royal Commission into the collapse of HIH was released on 16 April 2003. While the Commissioner, Justice Neville Owen, was not critical of APRA's Board, he recommended that it be replaced by an executive group (or Commission) and that direct involvement of the RBA and ASIC in the governance of APRA be discontinued:

> While the [Wallis Report's] aim of promoting cooperation and a broader perspective was laudable, the concept of the representation of agencies at board level was, I believe, misconceived... Requiring a person who is responsible for running one regulatory agency to become involved in the governance of another agency can only tend to cloud and complicate his or her focus. In my view the APRA model also places the chief executive of APRA in a difficult position. Not only does the chief executive have to account to a board, as well as the Treasurer, but there is a co-agency executive assessing conduct.
>
> There is also a risk that the participation of RBA and ASIC representatives on the APRA board may impede as much as

105 Financial System Inquiry, *Final Report*, March 1997, p.536.

> improve coordination between the agencies at working level. There was some indication in the evidence I heard that staff may have assumed that necessary exchange of information would be occurring at board level obviating the need for communication at a working level.[106]

3.41 At the June hearing in Melbourne, the Governor indicated that he agreed with the Royal Commissioner's conclusions and was comfortable with the recommendations.[107] Legislation giving effect to Justice Owen's recommendation that APRA's Board be replaced by an executive group was passed by the Parliament in June 2003.

3.42 The Royal Commission envisaged an expanded role for the Council of Financial Regulators (a co-ordinating body for Australia's main financial regulatory agencies including the RBA, which chairs the Council) in strategic consideration of issues affecting the financial services sector. As explained by the Governor:

> I think the point that Mr Justice Owen was making was that this was a very good body but it had been slightly sidelined by the fact that the members of it were also, by and large, members of the APRA board. So the work that they would normally have been doing at the quarterly meeting of the Council of Financial Regulators they were doing in their monthly APRA board meetings. So the APRA board had become, de facto, also the Council of Financial Regulators… Under the new arrangements, that will not be the case. The Council of Financial Regulators will be the peak body to make sure that coordination occurs at the highest level between ASIC, APRA and the Reserve Bank. I think that is a good solution.[108]

3.43 The Council's most recent Annual Report states that the changes to APRA's management structure "will place even greater emphasis on the information exchange and co-ordination functions of the Council". Co-operative arrangements have been set out in agreements between the RBA, APRA and ASIC, covering such matters as information-sharing, prompt notification of regulatory decisions likely to impact on another agency's area of responsibility, consultation arrangements in the event of financial disturbances and

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106 HIH Royal Commission, *The Failure of HIH Insurance*, Vol 1, Chapter 8, "Regulation of General Insurance", April 2003, see pp.206-226.

107 *Official Hansard*, 6 June 2003, Melbourne, pp.66-67.

108 *Official Hansard*, 6 June 2003, Melbourne, p.68.

establishment of Co-ordination Committees to avoid "overlaps and gaps in regulatory coverage".[109]

3.44 At the June public hearing the Committee also questioned the Governor on whether responsibility for prudential regulation of the banks should be returned to the RBA. Mr Macfarlane responded that "we have no desire to turn the clock back" and stated that bank regulation "has gone extremely smoothly". He also noted that out of the Wallis report the RBA had gained a new responsibility – regulation of the payments system – which "has been, over the last 10 years, at least as intellectually demanding as bank regulation" and which involves constant contact between the RBA and the banks.[110]

Foreign investment

3.45 At the June public hearing the Governor was asked for his views on the trend, in recent years, for simultaneous large capital flows into and out of Australia. He noted that:

> It is just part of the way modern developed economies behave in an integrated world… Over the last decade in Australia our liabilities to the rest of the world – because of money that has come in – have gone up by 47 percent of GDP. At the same time, our assets – what the rest of the world owes us because of what we have invested abroad – have gone up by 40 percent. So there are very big movements on both sides. Some people might be worried about that but, to reassure you, let us look at a few other countries. If we look at Germany, for example, the figures were 88 percent and 71 percent. If we look at the United Kingdom, the figures were 168 percent and 164 percent. This is just the nature of the way modern developed economies behave in an integrated financial world. We own a lot more of them than we formerly did. They own a lot more of us than they formerly did. I do not see that as in any way being an increase in risk.[111]

3.46 In response to a query from the Committee as to the extent to which overseas borrowing by Australian banks is funding this investment overseas, the Governor noted that "a lot of what we are calling inflow

109 Council of Financial Regulators, *Annual Report 2002*, p.16.

110 *Official Hansard*, 6 June 2003, Melbourne, p.67.

111 *Official Hansard*, 6 June 2003, Melbourne, p.57.

into Australia is Australian banks borrowing offshore".[112] He indicated that it is presently cheaper for banks to borrow offshore in foreign currency, then swap that foreign currency back into Australian dollars so as to have themselves in a hedged position. This does not amount to the banks taking a foreign currency risk.

Credit derivatives

3.47 The Committee questioned the Governor about the rapid international growth in the use of credit derivatives (which in essence allow lenders to sell their credit risks to other parties).[113] According to the Bank for International Settlements, the international value of such instruments has increased from US $0.9 trillion at the end of 2000 to an estimated US$2 trillion at the end of 2002.[114]

3.48 The Committee asked the Governor whether there is adequate disclosure of the level of credit derivatives being used by Australian financial institutions and the risks, if any, to the Australian economy.

3.49 The Governor responded that the growth in credit derivatives in Australia is happening on a smaller scale than in either the US or Europe. He noted that the RBA's Systems Stability Department deals with financial stability issues, examining the financial risks that occur in the community as a result of factors such as the changes in products, the growth of derivative markets and the growth of credit derivatives. The same department supports the Governor in his membership of the Financial Stability Forum, an international body which Mr Macfarlane advised is monitoring the use of credit derivatives.[115]

112 *Official Hansard*, 6 June 2003, Melbourne, p.57.

113 For further information see Reserve Bank of Australia, "Credit Risk Transfer Markets: An Australian Perspective", *Bulletin*, May 2003, pp.55-62. See also "Pass the Parcel", *The Economist*, 16 January 2003, and discussion of collateralised debt in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, pp.21-22.

114 Working Group established by the BIS Committee on the Global Financial System, *Credit Risk Transfer*, January 2003, p.13 at www.bis.org/publ/cgfs20.pdf (as at September 2003).

115 *Official Hansard*, 6 June 2003, Melbourne, p.68 and pp.71-72.

Margin lending

3.50 Margin lending for investment in shares has increased substantially in recent years. At the June public hearing the Committee asked the Governor whether the RBA should be providing cautionary advice on margin lending, as it has for speculative investment in property. The Governor distinguished margin lending for shares from property investment in the following terms:

> The difference is, No. 1, when you buy a share, you know the price of it every day. No. 2, if your gearing goes up because your equity is declining, your banker phones you up and makes you put in some more equity the same day. So it is exactly analogous to the negative gearing of property, but it is closely monitored on a day-to-day basis. The problem with the negative gearing of property is that you do not know what the thing is worth and maybe you are going to get a rude shock in two years time – but you will not know it until two years time. If it were a margin loan on shares, you would be reminded of it every day and you can cut your position whenever you want to.
>
> …I think the orders of magnitude are quite small. They are nothing like what we are talking about on investment property.[116]

3.51 The RBA’s Assistant Governor (Financial Markets), Mr Ric Battellino, reiterated this last comment and added that:

> We started collecting data on this a few years back, because the industry started to grow. The thing that has come out of it is that the banks are really quite conservative in lending in this area. The maximum they will lend is 70 percent and, on average, the customers are even more conservative. The average they borrow against their shares is about 50 percent. We were worried about what would happen – this all started when the share market was going up – when the share market goes down. We have had some reasonable tests of that because a lot of these margin loans were against Telstra shares et cetera, which have gone down a fair way. It turns out that the customers have no trouble making margin calls at all. Even though the number of margin calls has gone up a lot, the system has worked very well. Nobody at this stage

116 *Official Hansard,* 6 June 2003, Melbourne, p.72. See also *Official Hansard,* 6 December 2002, Warrnambool, pp.33-34.

> seems to be getting into big trouble on this thing, but it is something we are watching very closely.[117]

The international security environment

3.52 At the Warrnambool hearing the Committee asked the Governor about terrorism and money laundering. He noted that after the terrorist attacks on New York on 11 September 2001, the Government had implemented measures designed to identify bank accounts used by terrorists and related groups.

3.53 At that time, the only mechanism available to block bank accounts was the Banking Act's foreign exchange control mechanism, which was a partial solution as only international transactions could be blocked from the relevant accounts. The Governor explained that more effective new legislation (the Charter of the United Nations (Anti-terrorism Measures) Regulations), principally administered by the Department of Foreign Affairs and Trade, had been introduced. The regulations apply to any restrictions that are imposed through the UN framework, with the RBA retaining "a very small residual role" in freezing accounts where the decision is unilateral, rather than through UN co-operation.[118]

Foreign reserves

3.54 The RBA noted at the Melbourne hearing that about 18 months previously it had made a decision to increase the proportion of its reserves held in euro. Australia is now one of the few countries to have as many reserves in euro as in US dollars; the current rations are 45 percent euro, 45 percent US dollars and 10 percent yen.

3.55 The Governor explained that the change was not driven by a desire to "play the market":

> …the motive was a much longer run view of how the world might evolve over 20 years. In fact, that was part of the decision to reduce our holdings of yen – that was the main motivation for our change. We took what used to be in yen

117 *Official Hansard*, 6 June 2003, Melbourne, p.72.

118 *Official Hansard*, 6 December 2002, Warrnambool, p.34.

> and put it into euro, which built the euro share up to the US dollar share.[119]

Transparency of the RBA

3.56 On the morning of the public hearing in Melbourne, *The Australian* newspaper carried a front-page article indicating that the RBA's Board was split on the need for a reduction in interest rates.[120] The article stated that Treasury Secretary and Board member Ken Henry had argued unsuccessfully for a reduction, reflecting Government concerns about the rapid rise in the Australian dollar, the impact of the drought and continuing doubts as to the strength of the world economy.

3.57 *The Australian* asserted that:

> Treasury and the Reserve Bank have been at odds over the dangers of a booming housing market and rising household debt levels… Treasury has been less worried about rising debt levels because of the steady increase in property values.

3.58 In response to questioning from the Committee, the Governor stated that differences of opinion between the RBA and Treasury at Board meetings are common, and asserted there is "absolutely no conflict whatsoever" between the RBA and the Government:

> I think what you have seen this morning is an overenergetic official somewhere in the bureaucracy who has tried to blunder into the debate; I am not suggesting for a minute that Dr Henry would be that official. This is not an example of conflict between the Reserve Bank and the government, and I think the government would be very irritated, just as I am rather irritated, when I see people blunder in that way.[121]

3.59 The transparency of the RBA and the decision-making process at Board meetings has been the subject of discussion between the Committee and RBA at previous public hearings.[122] In its August 2002 report on the RBA's *Annual Report 2001*, the Committee noted that the US Federal Reserve Bank, for example, makes an

119 *Official Hansard*, 6 June 2003, Melbourne, p.65. See also *Official Hansard*, 6 December 2002, Warrnambool, p.13.

120 "Reserve Split On Need for Rate Cut", *The Australian*, 6 June 2003, pp.1-2.

121 *Official Hansard*, 6 June 2003, Melbourne, pp.49-50. See also pp.51-52.

122 See House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002.

announcement after every Board meeting. When it decides not to change interest rates it nevertheless states its reasons and indicates whether it is presently biased towards a later increase or decrease. The RBA, in contrast, only provides an explanatory statement of decisions on rates at Board meetings when the rate is adjusted.

3.60 At the May 2001 hearing, the Governor suggested to this Committee's predecessor that statements after every Board meeting were not required and that monthly statements would unduly concentrate debate on short-term monthly data. The Committee endorsed these concerns in its subsequent report.[123]

3.61 This Committee, in its August 2002 report:

- noted comments by the Governor that a substantial amount of information is already available to markets;
- endorsed the one-line statements now posted on the RBA's website after Board decisions to leave the cash rate unchanged; and
- noted that the RBA's twice-yearly appearance before the Committee is a very effective means of making the RBA accountable to Parliament and the public.[124]

3.62 Given the press commentary on the morning of the June 2003 hearing, the Committee again questioned the Governor on whether the RBA should release either minutes of Board meetings, or broader statements on decisions taken at the meetings. Mr Macfarlane remains unenthusiastic:

> I do not think there is much value in doing that – other than enabling people to get a lot of stories about conflict. I do not think they are going to learn anything more about monetary policy by doing that.[125]

3.63 In September 2003 the RBA's Deputy Governor, Mr Glenn Stevens, commented that:

> …while it is natural for market participants and the media to want central banks to say more and more about their intentions… the future often turns up the unexpected – to which we need to respond by revising our intentions…

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123 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of the Reserve Bank of Australia Annual Report 1999-2000*, June 2001, p.28.

124 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002, pp.22-23.

125 *Official Hansard*, 6 June 2003, Melbourne, p.74.

> Secondly, because the future cannot be known, and because things can change quickly, people need some understanding of the principles which guide central bank behaviour. So there is probably more to be gained by continued efforts at articulating how our framework for policy works, than by providing ever more frequent commentary on events. [This] is the most helpful form of transparency – describing how we think about things and, within that framework, why we did what we did.[126]

3.64 Mr Stevens added that the RBA's most recent *Statement on Monetary Policy* (August 2003) "goes a good deal further down this track" than most of its predecessors.

3.65 The interest generated by the story in *The Australian* does not persuade the Committee that its earlier judgements on the RBA's public pronouncements need to be revised. The Committee's ongoing public hearings with the Governor, as well as public speeches by the Governor and Deputy Governor and the RBA's quarterly *Statement on Monetary Policy*, will continue to provide substantial insights into the RBA's thinking on monetary policy and other matters.

David Hawker MP
Committee Chair

November 2003

126 Quoted in Reserve Bank of Australia, *Bulletin*, October 2003, p.15.

A

Appendix A – Submissions

No.	From
1	Reserve Bank of Australia *Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, Warrnambool, 6 December 2002.*
2	Reserve Bank of Australia *Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, Melbourne, 6 June 2003.*
3	Reserve Bank of Australia *Answer to question taken on notice at the 6 June 2003 public hearing,* 30 July 2003.

B

Appendix B – Briefings, hearings and witnesses

Public hearings

Friday, 6 December 2002 – Warrnambool

Reserve Bank of Australia

Mr Ian Macfarlane, Governor
Mr Richard Battellino, Assistant Governor (Financial Markets)
Dr Guy Debelle, Head, Economic Analysis Department
Dr John Laker, Assistant Governor (Financial System)

Friday, 6 June 2003 – Melbourne

Reserve Bank of Australia

Mr Ian Macfarlane, Governor
Mr Richard Battellino, Assistant Governor (Financial Markets)
Dr Malcolm Edey, Assistant Governor (Economic)
Mr Glenn Stevens, Deputy Governor

Private briefings

Thursday, 5 December 2002 – Canberra

Mr Alan Oster, Chief Economist, National Australia Bank

Thursday, 29 May 2003 – Canberra

Dr John Edwards, Chief Economist, HSBC Bank Australia