Transcript of Questions and Answer Session following a Speech by the Governor, Mr IJ Macfarlane to CEDA on "Some Recent Influences on the Exchange Rate" Thursday, 9 November 2000

JIM GALE, CEDA
Governor, thank you very much for a terrific speech. I am a total economic Neanderthal. I always thought money was to buy stuff with. But fortunately, I saw Ian Harper write an article not too many days ago which tended to reinforce my Neanderlithic attitudes, that it was about buying stuff. He figured that purchasing parity was actually not a bad thing to look at, rather than getting all hysterical about the actual value of the dollar vis-a-vis how many US dollars it bought. I am inclined to figure that an Aussie dollar buys around about 75 cents worth of stuff. I think Ian Harper put it at around about 72, 73 cents. In a subsequent article, Bill Shields, a couple of days later, thought it was more like around about 65 cents. But has the RBA done any work on that? What do you think a fair parity price for the dollar is?

GOVERNOR
Thank you very much. The question you ask is a good one. It is a good one because you are bringing out a characteristic of exchange rates which people tend to forget, and that is in the very long run there are some relationships which tie an exchange rate down. It can't keep moving forever in one direction if inflation is under control.

Essentially, in the long run, there are various relationships that tie an exchange rate down. One of the best known ones is purchasing power parity, which is the one that Ian Harper was referring to. That essentially says that, in simple terms, if our rate of inflation is the same as the rate of inflation for the rest of the world - which it has been for the last decade, and will continue to be so - there is only a limited distance which an exchange rate can move. As it moves down the currency becomes more and more competitive. All sorts of forces come into play, one of which we have seen recently with the 25 per cent increase in Australian exports. And there is a limit to how far it goes. In the long run, relationships like purchasing power parity or its first cousin, measures of competitiveness, mean that even though you can move away for a reasonable length of time, as long as the inflation constraint is not relaxed the system eventually reverts to some sort of equilibrium level. It might only stay there for a short time and go off in the other direction, but it cannot continue to depart as long as the system is tied down by a rate of inflation which is roughly the same as the trading partners. Now, as to whether Ian Harper is right when he says 75 cents, or the economists at Macquarie Bank who say 65 cents, I don't know. I do not know. I am confident that the equilibrium exchange rate is higher than where we currently are. I am not going to go any further than that.

ROBERT WEBSTER, IBSA
Governor, you spoke about the strengths in the Australian economy in your speech. What about the weaknesses? What are the weaknesses and what can you do about it through your supervision of monetary policy?

GOVERNOR
Now, that is a pretty mean question. Would you say that to the Treasurer? Would you say "Please give me a long list of what you see as the weaknesses of the Australian economy?" We are trained to look for the strengths and when we find a weakness to do something about it so it is no longer a weakness. There are enough people out there each day coming up with long lists of weaknesses. I don't think I want to add to that list, Robert.

TERRY McCRANN, JOURNALIST
Do we conclude from your comments about the high-tech sector that you believe the Government has got it about right by not seeking to force-feed high-tech development in Australia by its decision on digital television, to postpone any activity in that area for ten years? But the substance of my question, really, is on another subject: could you comment on the debate over fiscal policy as it applies to particularly the exchange rate, but also to monetary policy? I mean is $500 million on the budget significant at all in this context?

GOVERNOR
If we are talking about large movements in fiscal policy, for example, a large movement towards expansion insofar as it caused the economy to speed up and that speeding up has some implications for inflation, then it would have an implication for monetary policy. So if we are talking about very large movements, you can't deny that it will have an influence on monetary policy. That is a forward-looking statement. In a backward-looking sense, we have been well served by our fiscal policy here. I don't think it has had an impact on - certainly, it hasn't had an adverse affect on - the exchange rate, because I think international investors don't go into the fine detail. They simply look at a country and say, "Look, their stock of Government debt to GDP is very low in Australia, extremely low; budget surpluses for four years". So I think, internationally, our fiscal policy is held in reasonably high regard. So I do not, for example, subscribe at all to that minority view that fiscal policy has had anything to do with the movement in the exchange rate over the last year.

JOHN HARKNESS, PRESIDENT CEDA
Could I ask a question with the prerogative of the Chair here? Over the last little while there have been some beautiful graphs that have been put together which related to the boom in the US, and related specifically to the value of household assets, the income which was being received in US households, and the expenditure of almost every dollar and probably a bit more. I understand there have been similar graphs done here in Australia which show the same sort of trend. Do you see that as an impact which we are going to see a longer term issue flow from; and if so, to what extent are they taken into account in current settings?

GOVERNOR
I think I am familiar with the stuff in the US which some of the investment banks have been putting out, which show a close correlation between consumption and the movement in the share market, or household wealth, with the share market being the predominant influence on that in the US recently. I think these sort of wealth affects are very real in the US, and particularly through that period when the US share market was going up very, very strongly. I think that was one of the things that contributed to the extreme buoyancy of the US economy.

Of course, now, we have had a year, 2000, where the share market has fallen. The broad measures have fallen by a small amount and the NASDAQ has fallen by a large amount. So I think some of that steam has gone out of US consumption, and that is one of the reasons why I think the majority view is that there will be this soft landing in the US.

As for Australia, we never had the excesses. We never had the really rapid increase in share prices that they had in the US and, at the moment, we haven't really had a fall. I mean the All Ords and the ASX200 are still sort of moving up. So I think that is yet another example of where we look quite good. We didn't have the excesses and we haven't had a correction. So I think the trends in household wealth in Australia are more moderate, and they are more consistent with just chugging ahead with decent consumption growth in the year ahead.

IVAN DEVESON, CEDA

I introduce myself as Ivan Deveson: an admirer of Ian Macfarlane who I believe is doing a good job as the leader of our Reserve Bank. So give me a favourable answer, Ian.

Two unrelated questions, if I may. Do you have a general comment about whether the world institutions, such as the Reserve Bank, are adequately organised to cope with the impact of the global economy, particularly the dot.com impact on that economy? And, given your recent report, would you care to comment about bank fees and charges?

GOVERNOR

The first one, are institutions adequately organised to cope with the world economy: well, no-one is ever a hundred per cent right. We spent a lot of time thinking about how the financial institutions of the world were prepared to cope with the Asian crisis, and I think we felt that there were a number of things which were not very well organised, and we have made our opinions known on that. For example, two simple things. We thought that the fact that hedge funds had neither any regulation nor any obligation to disclose was a severe weakness in the system. We also felt that when a crisis occurred and there was a capital flight, the absence of any international arrangements akin to domestic bankruptcy arrangements whereby there could be a sort of a stand-fast was another serious weakness. So we have put a lot of effort into the international fora to encourage improvements in those directions. That is only two. But that is two that Australia has played a very strong advocacy role in.

The second question was about bank fees. The only aspect of bank fees that I can really comment on, on the basis of recent knowledge, is a report that we released on what are called interchange fees, which is the wholesale structure of fees between banks that underlays the credit card system, the debit card system and the use of ATMs. We have put out a report on that, a very carefully researched report, and if anyone is interested in that subject they should read it. We have put it out for public discussion. We don't necessarily feel that we have said the last word on the subject, nor are we playing a role in enforcing any particular activity, although the ACCC - which is also looking into an aspect of it, an aspect that deals with credit cards - is playing a role in its capacity of enforcing the Trade Practices Act. But we put our piece out as a piece of research, and we are waiting for people to respond, obviously for the banks to respond, and for anyone else who has an interest in the subject.

JOHN HARKNESS, PRESIDENT CEDA
Governor, you have made all sorts of wonderful and beautifully careful comments in your special area. I would like to ask you to speculate slightly on the possible impact of a George W. Bush victory in the United States. Conventional wisdom today in Australia seems to be that it would be beneficial to Australia; but would you like to comment on how you see things? That would be a safe speculation for you to make. Thank you.

GOVERNOR
I don't think there is anything I could possibly add that hasn't already been written in the newspapers on this subject. The only comment I will make is every time Bush pulled ahead the US dollar went up, and every time Gore pulled ahead the US dollar went down. In my view that does not imply any assessment of the personal worth of the two parties concerned; but that is the way the foreign exchange market was behaving. So it is probably perverse.

GRAEME SAMUEL, NATIONAL COMPETITION COUNCIL
Governor, you spoke of the convergence of US and Australian interest rates, leading to a diminution in international appetite for Australian assets. Would it be realistically possible to bring about a divergence of those interest rates without killing the Australian economy, bringing about a hard end?

GOVERNOR
Yes. It is a good question, Graeme. I mean, basically, it is a sign of how much we have improved, that our interest rates are almost indistinguishable from US interest rates. Our long bond rate is 25 basis points higher, which is just negligible; and at the short end, we are 25 basis points lower at the very shortest end. But the yield curves, when you put them on each other, they look very, very similar. That is a sign that we have finally entered the international league, where people are willing to lend to Australia on almost the same terms they were prepared to lend to the US. That is something we should be proud of. And if someone said, "Oh, you know, it would be nice to return to the old days" - they weren't good old days, they were bad old days, when everyone was paying 300 basis points more than they needed to because of the risk associated with Australian paper. No-one wants to return to those days. So, you are right, in order to return to those days you would have to sort of semi-wreck the Australian economy.

ANDREW HANLON, MACQUARIE BANK
Ian, I am just wondering if you could comment a little bit more on your views on the strength of economic growth. From recollection, the Reserve Bank is on record as expecting the economy to grow by 4 per cent, or more, over the coming year. Is that still your view? And, if so, how do you reconcile that with job vacancies down by 17½ per cent over the last year and employment falling in the last two months, and retail sales contracting over the last year?

GOVERNOR
I don't think retail sales contracted over the last year. That is the first thing I would say. We can't turn this into a forecasting session. Basically, our views on economic growth haven't changed. You can always find a few weak signs. That is what happened, as I was explaining, in the first half of the year. People got themselves so excited about a few signs of weakness. It

doesn't take that long, you don't have to go back very far to remember when everyone was sitting there thinking that the first quarter GDP was going to be a negative. That is how pessimistic people got in the first half of the year. It turns out, of course, that the economy was growing at 4½ per cent. You can always find some weak indicators, and particularly if you just look at one month or two months. I mean, that employment situation, we had a phenomenal growth of employment. We had employment growing at 3.6 per cent per annum. That doesn't sound like a huge number for GDP, but that is a huge number for employment. At some point it had to return back to a more sustainable trend. A good trend for employment would be two and a half per cent or so, and we are sort of moving back towards that. But as you move back, you don't ever do it in a smooth way; you do it in a couple of jumps or blips, and people tend to read a lot into that. But, no, our assessment on growth for the Australian economy hasn't changed.

STEPHEN GERHARDY, WOODSIDE ENERGY
I just want to ask you, you referred to the hedge funds and their role in the Asian crisis a couple of years ago. What has changed since 1997, in your view, to prevent a repeat of 1997?

GOVERNOR
There is a simple answer, in that the two hedge funds that caused the most trouble have gone broke; that is not true, one of them went broke and the other one has scaled back its activities to a very small scale. That is such a high risk activity, you know. You can win some, you lose some. You can be a big man in one year and you can be walking around with your tail between your legs the next year. Essentially, I think some of those big bets they took, which were working for a while during 97 and 98, in the end turned out badly. And, of course, the biggest and the most sophisticated of all of them, Long Term Capital Management, is also no more. So at the end of the day the irony is there. I think that the market sorted that out, and they beat the regulators. We were trying to get them to disclose their positions. But the big global macro funds, by and large, just lost so much money that they are not an important consideration now. There are still a lot of other hedge funds that are specialists in equities and what have you, which have got a much narrower and more specialised role, and many of those are probably doing quite a useful role. But the ones that were causing the problems in 97 and 98 are by and large no more with us.

CHAIRMAN
Thank you very much, Governor.