



**Review of the
Reserve Bank of Australia
Annual Report 1996-97
Interim Report**

Report from the House of Representatives Standing
Committee on Financial Institutions and
Public Administration

March 1998

The Parliament of the Commonwealth of Australia

**Review of the
Reserve Bank of Australia
Annual Report 1996-97
Interim Report**

Report from the House of Representatives Standing
Committee on Financial Institutions and
Public Administration

March 1998

House of Representatives Printing Service
Canberra

© Commonwealth of Australia 1998

ISBN 0 642 36601 2

Produced by the House of Representatives Printing Service, Canberra

CONTENTS

FOREWORD	v
MEMBERS OF THE COMMITTEE	vii
TERMS OF REFERENCE	ix
ACRONYMS AND ABBREVIATIONS	xi
RECOMMENDATIONS	xiii
CHAPTER ONE: INTRODUCTION	1
Background	1
Scope and conduct of the review	2
CHAPTER TWO: CONDUCT OF MONETARY POLICY AND SURVEILLANCE OF THE FINANCIAL SYSTEM	5
Conduct of monetary policy	5
Asia and the rest of the world	9
Effects of the Asia crisis on Australia	10
Level of unemployment: the economic problem that remains	12
Gold	13
Surveillance of the financial system	14
Wallis inquiry: Implications for the RBA	14
Payments system	15
Bank lending and bank margins	16
Approach to bank supervision	17
"Year 2000 problem"	18
Central bank cooperation	19
APPENDIX 1: LIST OF SUBMISSIONS	21
APPENDIX 2: LIST OF HEARINGS AND WITNESSES	23
Private Briefings	23
COMMITTEE'S REVIEWS OF ANNUAL REPORTS	25
38th Parliament	25
37th Parliament	25
LIST OF TABLES	
Table 2.1 Margin over the Cash Rate	16

FOREWORD

This is the second report from the Committee in this Parliament on its public hearings with the Reserve Bank of Australia. This interim report addresses the Committee's November hearing and the Bank's November semi-annual statement on monetary policy. Those hearings have been very successful in clarifying the the banks role in the conduct of monetary policy and have attracted significant interest with the public, financial sector and the media. As such the hearings have been an important avenue for enhancing the transparency and accountability of the Bank.

The Committee's November hearing with the Reserve Bank was very timely, coming just after the onset of the currency crisis in Asia. The hearing provided valuable insights into the Bank's thinking on those crucial issues at that time. The Committee will follow up developments on these matters when it meets with the Bank in May this year.

The Committee's task at the hearings has been greatly facilitated by the cooperation and assistance provided by Ian Macfarlane, Governor, his Deputy Governors and the staff of the Reserve Bank of Australia. The Committee also appreciates the briefings it received from Mr Barry Hughes, Chief Economist, CS First Boston and Mr Ivan Colhoun, Senior Economist, Deutsche Morgan Grenfell (Australia) in the lead up to the hearing. It has been useful for the Committee to see some of the significant issues from slightly different perspectives.

I thank all the members of the Financial Institutions and Public Administration Committee for their hard work at the public hearing and for their contributions to this interim report.

David Hawker MP
Chairman

MEMBERS OF THE COMMITTEE

Chairman	Mr D P M Hawker, MP
Deputy Chairman	Mr G S Wilton, MP
	Mr A N Albanese, MP
	Mr L J Anthony, MP
	Mrs F E Bailey, MP (to 12 December 1996)
	Hon I R Causley, MP
	Mrs C A Gallus, MP
	Mr J B Hockey, MP
	Mr M W Latham, MP
	Hon S Martin, MP (from 17 November 1997)
	Hon B McMullan, MP (to 17 November 1997)
	Mr S B Mutch, MP
	Dr B J Nelson, MP
	Mr C M Pyne, MP
	Dr A J Southcott, MP (from 12 December 1996)
	Hon R Willis, MP
Secretary	Mr C Paterson
Inquiry Secretary	Ms B Forbes
Adviser	Mr P Hanratty
Inquiry Staff	Ms B Zolotto

TERMS OF REFERENCE

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

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

The *Reserve Bank of Australia annual report 1996-97* was tabled in the House of Representatives on 1 September 1997.

ACRONYMS AND ABBREVIATIONS

APRA	Australian Prudential Regulation Authority
ASEAN	Association of South-East Asian Nations
AWOTE	Average weekly ordinary-time earnings
EMEAP	Executive Meeting of East Asia and Pacific Central Banks
IMF	International Monetary Fund
NAIRU	non-accelerating inflation rate of unemployment
RBA	Reserve Bank of Australia

RECOMMENDATIONS

- 1 That the Reserve Bank of Australia measure the actual impact of living wage claim outcomes against the Bank's expectations of what it would be in terms of the comments the Bank made at the time. (paragraph 2.20)

- 2 That the Reserve Bank of Australia and the Australian Bureau of Statistics assess how significant a component executive salaries is of average weekly ordinary-time earnings (AWOTE). (paragraph 2.21)

CHAPTER ONE

INTRODUCTION

Background

1.1 In the recent Asian currency crisis the value of the transparency and accountability of Australian financial institutions has been clearly demonstrated. One of the valuable features of the Australian system is that Australian financial institutions strongly support such openness.

1.2 That transparency and accountability will be even further enhanced as a result of the reforms set out in the Wallis Report.¹ The recommendations of that report have been accepted by Government and provide the blueprint to take the Australian financial sector into the next century.

1.3 For the past five years the House of Representatives Standing Committee on Financial Institutions and Public Administration, or its predecessor committees, have reviewed the annual reports of the Reserve Bank of Australia (RBA).

1.4 The basis for those reviews is House of Representatives' standing order 28B(b) whereby annual reports within a committee's area of portfolio responsibility stand referred for any inquiry the committee may wish to undertake (see terms of reference at page *ix*).

1.5 Those reviews have been an important avenue of accountability and transparency for the RBA and have provided the parliament, financial sector and community, with valuable insights into the way in which the RBA conducts its activities and monetary policy and the basis for its decisions. This opportunity for scrutiny and discussion builds on the RBA's own information dissemination programs which put out the Bank's views on a wide variety of topics.

1.6 In August 1996 the RBA's accountability framework was extended and more formalised. The Treasurer, the Hon Peter Costello MP, and the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane, agreed on a *Statement on the conduct of monetary policy*² which set out a common understanding between the Governor and the Government on key aspects of Australia's monetary policy framework. The Bank also decided to table a *Semi-annual statement on monetary policy* and modified its program of publishing quarterly reports to achieve this. Further, it was agreed that the Governor would appear before the Financial Institutions Committee twice each year to report on the conduct of monetary policy.

1 *Financial System Inquiry final report*. March 1997. Canberra, AGPS, xv 771p.

2 *Reserve Bank of Australia report and financial statements 30 June 1997*. 1997. Sydney, RBA, pp 8-10.

1.7 These arrangements were described by the Treasurer as '...a valuable step forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy - and therefore the credibility of policy itself.'³

1.8 The Committee and the RBA subsequently decided that the appearances of the RBA before the Committee would take place in May and November each year.

1.9 The Committee has held two meetings with the RBA under these new arrangements, and both groups agree that the arrangements are working well. There has been considerable public interest in the proceedings.⁴

1.10 This work by the Committee on the RBA is part of the Committee's broader framework for reviewing the annual reports of several agencies in the financial services and public sectors (see the back of this report for a list of those reports).

Scope and conduct of the review

1.11 It is against this background that at its meeting on 4 September 1997 the Committee resolved to examine the Reserve Bank of Australia's annual report 1996-97 and the November 1997 semi-annual statement.⁵ On the 6 November 1997 the Committee held a public hearing in Sydney with the Reserve Bank of Australia to pursue those matters. Details of that hearing are set out at Appendix 2. A copy of the November statement was released to the Committee two hours prior to the hearing and widely distributed to others at the hearing and later. A copy of the transcript of evidence from the hearing has been published by the Committee and is available from its secretariat and on the Committee's internet site. Copies of the November statement are available from the Reserve Bank.

1.12 The Committee's review clearly is a public process. However, it is not as comprehensive as an inquiry into a specific reference, since the review is not formally advertised in the press, and submissions generally are sought only from those organisations directly involved in the review process.

1.13 The RBA made one submission to the review and that submission addressed small business lending (see Appendix 1).⁶

1.14 In the lead up to its hearing with the RBA, the Committee held informal briefings with two leading economists from the financial sector - Mr Barry Hughes, Chief Economist, CS First Boston and Mr Ivan Colhoun, Senior Economist, Deutsche Morgan Grenfell (Australia).

3 *Reserve Bank of Australia report and financial statements 30 June 1997*, op cit, p 10.

4 Evidence p 3.

5 *Reserve Bank of Australia report and financial statements 30 June 1997*, op cit, 91p.
Reserve Bank of Australia. *Semi-annual statement on monetary policy, November 1997*. Sydney, RBA, 40p.

6 The submissions and public hearing transcripts have been incorporated into a volume which is available for inspection at the National Library of Australia, the Commonwealth Parliamentary Library and the Committee Secretariat. References to the evidence in the text of this report refer to the page numbers in the submission volume ('S' prefix) and public hearing transcript (numeric sequence). Copies of the transcript and submission are also available on the Committee's internet site.

Those briefings presented alternate views on some aspects of the economy and monetary policy thereby suggesting some particular matters that might be raised with the RBA.

1.15 In undertaking its review the Committee examined both monetary policy and prudential matters. This interim report focuses on both. The Committee will report again on developments in these areas, after it meets again with the RBA in May this year.

1.16 In addressing monetary policy the Committee has not repeated the detail of the RBA's views as set out in the November 1997 statement, rather, it has highlighted a number of significant matters that were raised at the public hearing.

CHAPTER TWO

CONDUCT OF MONETARY POLICY AND SURVEILLANCE OF THE FINANCIAL SYSTEM

2.1 The *Statement on the conduct of monetary policy* concludes with the statement that 'The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.'¹ This was the starting point for the Reserve Bank of Australia's appearance before the Committee on 6 November 1997, whereby the Governor sought to be accountable for what he had said to the Committee at the previous hearing, as well as what he was going to say on the day.

Conduct of monetary policy

2.2 At the May 1997 hearing the RBA said that after a sluggish 1996 where GDP had grown at about 3%, it was expecting growth to pick up to about 4% in 1997 and expecting inflation to stay at the bottom of the 2%-3% range with the possibility that it could go a little lower for a while.²

2.3 In November, on the basis of available data - the first three-quarters of 1997 - the RBA said growth was as least as good as it expected in May (that is, an annual rate of nearly 4%), if not a little better. Major monthly indicators such as retail trade, imports, exports, and the labour market (especially vacancies and to some extent employment) were all pointing in that direction. Business surveys also provided some evidence that confidence was rising.³ The seasonally adjusted estimates for GDP(A)⁴ for the December quarter (the most recent available quarter) was 3.6% higher than the December quarter 1996 in real terms.

2.4 However, the outlook on inflation had changed a little from what the RBA had expected. New figures indicated underlying inflation was below 2% and the RBA's ongoing assessment caused it to lower its forecasts with the result that there were a further two easings in monetary policy - one in May and one in July.⁵

2.5 The RBA said an important contributing factor was the better outlook for wages than it had expected, where revised figures on wages and earnings, from the Australian Bureau of Statistics, suggested that the figures were lower than formerly thought or had been formerly published for the March quarter 1997. As a result an apparent upward trend in wages was revised away. These better wage figures basically continued from May to November, with the exception of the September quarter figures.⁶ The RBA stressed that all it can do on wages is

1 *Reserve Bank of Australia report and financial statements 30 June 1997*. 1997. Sydney, RBA, p 10.

2 Evidence p 4.

3 Ibid.

4 GDP(A) is the average of the three estimates of gross domestic product, the income, expenditure and production based estimates.

5 Evidence p 4.

6 Ibid.

to set very broad parameters. Overall, its aim is to keep aggregate wage changes in the corridor between 3.5% to 4.5%.⁷

2.6 The RBA also noted that financial conditions had clearly become easier since May. It pointed to the following changes from May to November: a reduction in the overnight cash rate from 6% to 5% as a result of the two easings in monetary policy; a lowering in yields of 10-year government bonds from 7.75% to 6%; the exchange rate against the US dollar down from 77.7c to 70.3c; and in trade-weighted terms it had come down from 60.2 to 57.⁸

2.7 The problem areas highlighted by the RBA were sluggish employment growth in the first half of 1997, some doubts about the strength of investment and the forthcoming effects of El Nino.⁹

2.8 The RBA expects inflation to move back into the 2% to 3% range probably towards the end of 1998.¹⁰ It also noted that 'Our feeling is that these [interest] rates, which are almost as low as any of us can remember in our working lives, are not constraining the economy.'¹¹

2.9 In response to the Committee's question on how the inflation target works, the RBA confirmed that:

...the situation is symmetrical. Other things being equal - unless there was some disturbance going on somewhere else - a prolonged undershooting would be a signal to reduce interest rates. In fact, that was a very important part of the last two easings of monetary policy in May and July.¹²

2.10 On inflation expectations, the RBA advised that it would like people to have an inflationary expectation of 2.5%, but the actual level is higher, probably about 3.4%.¹³

2.11 The Committee raised concerns about the current level of growth in household indebtedness. The RBA noted that an international comparison in its November statement¹⁴ indicated that the rate of increase in household indebtedness has been sharp and brings Australia's level close to that of the levels of the United Kingdom, Japan and the United States. The Bank advised that '...It is possible to responsibly run a bigger debt position in a low inflation environment, more so than it would have been in the mid-1980s, which was a higher inflation and, more particularly, a higher interest rate environment.'¹⁵ The RBA said it has started preaching a little on this issue, but there is not much more that it can do. The Committee will continue to monitor this matter at future hearings in May and November this year.

7 Evidence p 22.

8 Evidence p 5.

9 Ibid.

10 Evidence pp 14-15 and *Semi-annual statement on monetary policy, November 1997*, op cit, p 40.

11 Evidence p 20.

12 Evidence p 58.

13 Evidence p 29.

14 *Semi-annual statement on monetary policy, November 1997*, op cit, p 17.

15 Evidence p 41.

2.12 The predominant view is that monetary policy is stimulatory. In reaching its view the RBA said it does not use either the real cash rate (that is, the cash rate adjusted for inflation) nor the Monetary Conditions Index [which is used by the central banks in New Zealand and Canada] since those measures cannot be calculated with enough precision.¹⁶

2.13 The RBA is now taking a longer term focus on the impact of monetary policy than it has in the past and it suggests that monetary policy cannot finetune the business cycle.¹⁷ The Deputy Governor, Dr Stephen Grenville, believes the Bank has the degree of intervention in monetary policy about right saying '...We do not think we can finetune but, where we see a case for changing policy, we will be alert to that and do it.'¹⁸

2.14 The Committee also raised the issue of central bank credibility with financial market economists and their predictions of interest rate cuts and with wage negotiators with the Bank's statements and actions on wage settings. On the first issue, in summary, the Bank responded by saying that the market is always looking for a predictable rule, but if such a rule existed there would be no need for money market economists.¹⁹

2.15 On wage settings the RBA said:

...we are, and all central banks are, sensitive to wages and, given the history of the last couple of decades, probably a bit cautious there...the way those [wage] figures came out this year; it did not help logical policy making as much as it could have.

...wages are always going to be the biggest structural difficulty for Australia because...we are trying to return to a low inflation growth economy like we had in the fifties and sixties, after two decades of high inflation, and at the same time as trying to do it, we are actually going through a once in a century change to the wage setting structure in Australia.

[that is]...from a centralised to a decentralised system...²⁰

2.16 In its November statement the RBA said 'Recent developments in wages continue to be difficult to interpret...'²¹ The RBA's message is one of disappointment '...that earlier signs of slowing in growth of Australian labour costs do not appear to have continued, judging from the most recent data...'²²

2.17 In the November statement the RBA reported 'All measures of average earnings compiled in the Average Weekly Earnings survey showed a sharp jump in the three months to August...'²³, that is, average weekly ordinary-time earnings (AWOTE) increased by 1.6% in

16 Evidence pp 23 and 29.

17 Evidence pp 29-31; and See also Grenville, S. Deputy Governor, RBA. *The Reserve Bank and the business cycle. Melbourne Institute of Applied Economic and Social Research Conference on Business cycles: Policy and analysis, Melbourne, 5 September 1997.* in *RBA Bulletin, September 1997.* Sydney, RBA, pp 1-12.

18 Evidence p 31.

19 Evidence pp 20-22.

20 Evidence pp 22-23.

21 *Semi-annual statement on monetary policy, November 1997*, op cit, p 36.

22 *Ibid*, p 2.

23 *Ibid*, p 36.

the quarter; aggregate wages have continued to rise at about 1% per quarter; there has been a decline in growth of the private sector component, offset by unusually high outcomes in the public sector; and the flow-through of the recent safety-net decision would have contributed little to the August outcome.

2.18 While again stressing the difficulty of interpreting the recent figures, the RBA suggested: the trend decline in private-sector wage growth has come to an end despite underlying consumer price inflation running at 1.5%, producer price increases at a similar rate, and a flat demand for labour; wage increases as a result of enterprise bargains are showing some encouraging signs of becoming more realistic in workplaces with more experience with bargaining, although the average is probably still going up; growth in executive salaries remains stubbornly high and increasingly unrelated to trends in business conditions; and the Australian Council of Trade Unions has foreshadowed an additional award wages claim to be heard in early 1998 involving a 5.7% increase for those on minimum awards but a smaller proportion for those on higher awards, with an additional increase of \$38 in the subsequent year.²⁴

2.19 Given the controversy surrounding the RBA's comments in early 1997 on the effect of the safety-net decision, the Committee recommended the Bank evaluate its expectations against actual living wage claim outcomes.²⁵ The Committee also raised concerns about the changing significance of the contribution of the executive salaries component to the AWOTE, since it suspects there are more participants in this category than in the past. The RBA reported it had not done that assessment, but agreed it should be done.²⁶

2.20 Recommendation 1

That the Reserve Bank of Australia measure the actual impact of living wage claim outcomes against the Bank's expectations of what it would be in terms of the comments the Bank made at the time.

2.21 Recommendation 2

That the Reserve Bank of Australia and the Australian Bureau of Statistics assess how significant a component executive salaries is of average weekly ordinary-time earnings (AWOTE).

2.22 The RBA stressed the link between wage increases and employment noting that:

...Management says, 'The thing that worries us is not the wage rate per person but the wage bill,' and that they can keep the wage bill down by reducing the size of their work force. That sort of environment is not conducive to employment growth...²⁷

24 Evidence pp 42-43; and *Semi-annual statement on monetary policy, November 1997*, op cit, pp 2 and 36-38.

25 Evidence p 44.

26 Ibid.

27 Evidence p 43 and See Evidence p 45.

Asia and the rest of the world

2.23 In its November statement the RBA said 'Until October, financial markets were reasonably steady, and generally in an optimistic frame of mind...'²⁸ The instability in financial markets initially affected Thailand, then spread to Indonesia, Malaysia and the Philippines. At that time the wider impact was limited, but this changed in late October when the currency pressures extended more widely in Asia particularly to Hong Kong.²⁹

2.24 The RBA's outlook for Asian growth prospects in the long run remains very optimistic. It based this assessment on the following characteristics of the Asian economies: they can still achieve rapid productivity growth through technology transfer because they started a long way behind the frontier and have a long way to go; they are oriented towards international trade; they have very high savings rates, high investment and relatively small government sectors; they generally had, and still have, sound fiscal and monetary policies, although the soundness of their financial and banking sectors have some way to go; and they give a high priority to education.³⁰

2.25 However, it pointed to difficulties in those economies (particularly the ASEAN four) in the short run, noting that the problems confronting them have been around for some time but those problems have tended to be ignored and glossed over. Difficulties cited include sharp falls in currencies, stock markets and probably property prices. It said the principle problem will be how to handle the fall in previously over-inflated asset prices which were partly due to some undisciplined lending by local banks and foreigners and some very opaque interrelationships between business and government which have obscured the true financial position of a lot of companies and banks. There also appears to have been over-investment in some areas, particularly in the electronics area.³¹

2.26 Part of the adjustment that the RBA expects, will inevitably involve a sharp curtailment of growth in the short run and a contraction of credit, with falling imports which will have a flow-on effect to other countries.³²

2.27 The RBA advised that:

...For a time it looked as though the ASEAN problems would spill over to...[Korea, China, Taiwan and Hong Kong] in a big way. That seems less likely now, but we should not speak too soon. I think we should build in an assumption of some slowing in aggregate for these countries.³³

2.28 The RBA agreed that the real problem for Australia would be if difficulties of the South-East Asian countries flowed through to North-East Asia, for example, Korea and Japan, which is one of our biggest customers and the biggest economy in that region. The RBA noted that Korea has been going through one of these sorts of adjustments for a couple of

28 *Semi-annual statement on monetary policy, November 1997*, op cit, p 1.

29 Ibid, p 2.

30 Evidence pp 5-6.

31 Evidence p 6.

32 Ibid.

33 Evidence p 7.

years and Japan has been facing its banking problems for the past five years.³⁴ Since the hearing, the currency crisis did spill over into South Korea.

2.29 The situation in Asia is changing almost on a daily basis - obviously, the Committee will monitor events and discuss these matters with the Bank at the May hearing.

Effects of the Asia crisis on Australia

2.30 On the question of stability in financial markets, the RBA advised that 'We are in a much better position to handle this financial instability than we have been at any stage, I think, in the last quarter of a century...'³⁵

2.31 As expected the RBA stated that 'The outlook for Asia is the key uncertainty in assessing prospects for the Australian economy over the next year or two...'³⁶ The RBA predicted that the effects are likely to be '...a marked slowing in growth in some of Australia's Asian trading partners, with consequent loss of export sales and reduced income flows from foreign operations of Australian firms...'³⁷ and also suggested, other things being equal, the current account deficit will be higher than it was in 1997 and higher than the RBA would have been forecasting it to be three months before the hearing in November.³⁸

2.32 At the time the RBA was making its predictions it stressed there was no hard evidence at all, and it used as a guide what happened in 1984 and 1985 when there was also a big drop in ASEAN countries currencies and growth rates.³⁹

2.33 On the export side the RBA emphasised that the four ASEAN countries involved account for only 10% of Australia's exports. Like most commentators it linked lower growth and lower imports among the ASEAN four to lower exports and lower Australian GDP growth. It expects Australia to be in a period of weak exports to Asia. It said the forecast made by private sector analysts were roughly around one quarter per cent reduction in the GDP growth rate in Australia, with the OECD estimating 0.3% in 1997 and 0.4% in 1998.⁴⁰ At the time of the hearing, the RBA was unwilling to make a prediction on the impact of the Asian crisis on Australia's growth rate, as it thought at that stage it was far too early to do so.⁴¹

2.34 The RBA said 'If the difficulties were to remain confined to these four countries, the effect on Australia's exports and our growth would be modest. The rest of Asia is, in fact, a lot more important to Australia. Japan is still our largest market...'⁴²

2.35 The RBA also provided details of the support packages that Australia is providing, along with several other countries and the International Monetary Fund (IMF) to both

34 Evidence p 38.

35 Evidence p 8.

36 *Semi-annual statement on monetary policy, November 1997*, op cit, p 2.

37 Ibid.

38 Evidence p 28.

39 Evidence p 7.

40 Evidence pp 6-7.

41 Evidence p 27.

42 Evidence p 6.

Thailand and Indonesia in the current crisis. In summary, in the case of the Thai package which amounts to some US\$17 billion, the main contributors are Japan and the IMF. Australia is contributing US\$1 billion in the form of a central bank to central bank swap. Other contributors of US\$1 billion were China, Hong Kong, Malaysia and Singapore and contributors of half a billion dollars were Brunei, Indonesia and South Korea. There were also amounts from the World Bank and Asian Development Bank. Thailand carries the exchange rate risk and Australia earns a \$US interest rate.

2.36 In the case of the Indonesian arrangement, there are three tranches involving first the use of Indonesia's own international reserves of US\$20 billion, a second tranche involving the use of US\$23 billion basically from the IMF, the World Bank, the Asian Development Bank and some other Indonesian funds. Australia's contribution comes in the third tranche where Australia has pledged a loan of US\$1 billion along with several other countries, including the United States. The funds are held as international reserves and invested either in New York, Tokyo, Frankfurt, etc.⁴³

2.37 The Bank said the purpose of the packages is to stop a contraction from turning into a rout, the consequences of which may have flowed through to another country and had extremely severe consequences for Australia.⁴⁴

2.38 The RBA reported that the Government agreed to Australia's involvement in these two packages on the recommendation of various advisers, including the RBA. The RBA believes Australia should be involved because '...it is very much in our long-term interest to do so...'⁴⁵ The Committee obviously agrees. For Australia not to be involved, is to put tens of thousands of Australian jobs at risk.

2.39 Later in 1997 Australia was involved in a third multi-billion dollar loan rescue package of nearly US\$60 billion for South Korea. Again the package was put together by the IMF. In December Australia made available a third of the US\$1 billion it had already committed under that package.

2.40 The RBA also noted that the good growth record of the United States and the pick up in growth in the major European economies '...will help to provide a base of support for external demand and may, to some extent, mitigate some of the effects on Australia of the east Asian difficulties.'⁴⁶

2.41 On a more positive note, the Governor said '...I would have thought it is possible that these events will have some positive spin-off to Australia.'⁴⁷ For example, Australia may look to be a more attractive place to do business or set up a business compared with some of those countries than was thought six months ago re Australia's good infrastructure for commercial law, accounting practices, bank supervision, etc.

2.42 Further, the Committee pointed out that some forecasters have been indicating that they think that, despite the devaluation, the shake-out in Asia could be good for Australia for

43 Evidence pp 34-37.

44 Evidence p 37.

45 Evidence p 36.

46 *Semi-annual statement on monetary policy, November 1997*, op cit, p 12; and see Evidence pp 7-8.

47 Evidence p 39.

inflation, because there is likely to be, with considerable excess supply in Asian markets, a fierce effort by Asian countries to export at very competitive prices. This would indicate a lowering of prices more than the devaluation perhaps from those countries. This would give Australia, despite some Australian devaluation on the trade-weighted index, a benefit on inflation through a price effect in the initial prices in the original currencies of those countries. The Governor reported that the Bank had made allowance for that and perhaps too much allowance. He said, despite some of his staff being keen on that effect, he has been a bit more sceptical.⁴⁸

Level of unemployment: the economic problem that remains

2.43 The Bank suggested that from a longer term perspective, given Australia's newfound reputation for stability, many of the economic problems that were previously of concern have been eliminated or brought under some reasonable control. The major outstanding concern is the level of unemployment.⁴⁹

2.44 The Bank believes that while progress has been made in reducing unemployment (unemployment down from a peak of 11.2% to its present 8.6%), that progress has been disappointing particularly since there have been six years of expansion at an average growth rate of 3.6% per annum (the third highest average growth rate in the OECD area, exceeded only by Ireland and Norway, much smaller economies than Australia). It also noted that the reduction in unemployment appears to have gone unnoticed by the community.⁵⁰

2.45 The RBA predicted some further slow progress in reducing unemployment over the next year. It reiterated arguments that it put at the last hearing that, while monetary policy would play a part in achieving that reduction, in the long run, its part would only be minor. Compared with the previous two periods of economic expansion, the RBA is seeking to ensure a much longer expansion to reduce the likelihood and severity of any future slowdown to the greatest extent possible. To ameliorate inflation occurring at the late stages of the expansion, the RBA is taking a more medium term focus on monetary policy of which its inflation target is a central plank.⁵¹

2.46 The RBA remained reluctant to nominate other policy areas that would reduce unemployment because they are not its area of expertise. However, it pointed to some possible areas of structural change (such as flexible workhours; pay structures and wages; the structure of unemployment benefits; on-costs including payroll tax, workers' compensation, insurance; tax rates, etc) which it suggested together over time presumably would have a large effect. The Governor said he can see such policies starting to be addressed.⁵² The RBA argued that it is those structural factors which explain the lower levels of unemployment in the United States in contrast to continental Europe, not growth rates which are high in both locations.⁵³ This interpretation was not accepted by all Members of the Committee.⁵⁴

48 Evidence pp 15-16.

49 Evidence p 9.

50 Ibid.

51 Evidence pp 9-10.

52 Evidence pp 17-18.

53 Evidence pp 10-11.

54 Evidence pp 45-46.

2.47 On the non-accelerating inflation rate of unemployment (NAIRU), the Governor said '...In principle it is not bad but,...Because it cannot be measured with any precision we cannot use it as a guide for monetary policy, so I am not at all comfortable about using it in Australia. There are other things that you can use that perform a similar function...[for example,] the general amount of spare capacity in the economy and...how far GDP is from its trend growth, which will do a similar function...'⁵⁵

Gold

2.48 In the second half of 1996-97 two thirds of the RBA's gold holdings were sold (reduced from 247 tonnes to 80 tonnes) and the proceeds invested in foreign government securities. The sales achieved a large portion of the unrealised gains on gold holdings. On the announcement the price of gold fell from about US\$332 per ounce to a low of US\$317 per ounce, before recovering about half this fall in late July. To avoid reducing official reserve assets, the Treasurer agreed to the RBA retaining the proceeds of the sale. The RBA immediately invested the proceeds of the June deliveries in foreign exchange and a similar approach will be adopted with the final deliveries.⁵⁶ As of the first week of March the price of gold was US\$295.

2.49 Over the past five years a number of central banks (such as those of Austria, Belgium, Canada, Netherlands, Portugal and South Africa) have sold gold from their reserves.⁵⁷

2.50 At the time of the announcement of the official sales of gold there was strong criticism from the gold industry and perceptions of conflict of interest for RBA Board member (and WMC chief executive) Hugh Morgan.

2.51 In evidence the RBA stressed that in taking its decision to sell the gold it did take into account that Australia is a major gold producing country and considered that the relatively small amount of gold it sold would have a short run influence, but would not have a long run influence on the price of gold. It acknowledged that because of the nervous market, there was a bigger short run influence than expected at the time of the sale.⁵⁸

2.52 Questions were also raised about the timing of the sale and press claims that some market participants had been told of the sale by reporters before the embargo was lifted on the RBA press release announcing the sale. The RBA stated that 'Once we had sold it [the gold] forward many months earlier, it determined for us that the announcement would have to take place in the first week of July...'⁵⁹ The RBA did not consider the press embargo had been breached as '...if the embargo had been broken and someone had taken advantage of it, the price would have moved. The price of gold did not move until the embargo was lifted. Our

55 Evidence pp 23-24.

56 *RBA report and financial statements 30 June 1997*, op cit, pp 23-25.

57 *Official sales of gold*. Reserve Bank media release, 3 July 1997. in *RBA Bulletin, July 1997*. Sydney, RBA, p 34.

58 Evidence pp 51-53.

59 Evidence p 52.

judgement would be that, even if someone had heard it, no-one had taken commercial advantage of it.⁶⁰

2.53 Regarding conflict of interest of Board members, the RBA just accepts that there is a certain risk if you want to have lay members on the Board. It said, like any private company board it also has some mechanisms in place to deal with potential conflicts of interest, that is, people who work for a financial institution or have a directorship of a financial institution cannot be on the Board; Board members have to sign a secrecy declaration; and Board members have to notify the Bank, and keep updated, details of any commercial involvements they have.⁶¹

2.54 It was suggested that the Board's transparency could be enhanced by publishing its minutes like the US Fed does. The RBA did not support publishing its minutes as: it did not consider this as effective in keeping the public informed as its publications and the Committee's hearings; it believes the audience would be limited - mainly academics; and the contents of the minutes are very limited.⁶²

2.55 While the Committee believes there would be a wider interest, it is not convinced that it would be appropriate to change current procedures.

Surveillance of the financial system

Wallis inquiry: Implications for the RBA

2.56 On 2 September 1997 the Government accepted⁶³ almost all of the Wallis Report⁶⁴ recommendations, except those relating to continuing restrictions upon mergers between the four largest banks. Many of the recommendations have profound implications for the future role of the RBA.

2.57 Bank supervision is to be taken away from the RBA and lodged with a new prudential regulator, the Australian Prudential Regulation Authority (APRA), which will be responsible for all prudential regulation throughout the financial system. On the other hand, the RBA will continue to be responsible for monetary policy; overall financial system stability and the provision of liquidity; and regulation of the payments system.

2.58 The RBA stressed that while it had argued in favour of it retaining bank supervision, now that the decision has been taken that those responsibilities will go to APRA, it will work to ensure that the new system works as well as possible. It clarified its role in system stability, noting the international nature of many of the policies that influence this because of adherence to the Basle capital requirements. It also stressed that it is critical that the implementation of

60 Evidence p 51.

61 Evidence p 50.

62 Evidence pp 50-51.

63 See Statement by the Treasurer, the Hon Peter Costello, MP. *Reform of the Australian financial system*. Press release, 2 September 1997, 8p and att.

64 *Financial System Inquiry final report*. March 1997. Canberra, AGPS, xv 771p.

the systems be managed carefully since many of the new arrangements will be implemented simultaneously.⁶⁵

2.59 The Government is seeking a sound working relationship between the RBA and APRA and the current situation in Asia demonstrates the importance of achieving this.

2.60 In its last report on the RBA the Committee suggested that there was considerable value in the Committee continuing and extending parliamentary scrutiny of the new prudential supervisory arrangements. Accordingly, the Committee recommended that the new APRA appear before it once a year to report on prudential supervision of the financial services industry.⁶⁶ At the time of drafting, there had been no Government response to that recommendation, but one is expected from the Treasurer shortly.

Payments system

2.61 In 1995 the Australian Payments System Council stated that 'Delays in the availability of cheque proceeds, and a belief that banks have access to funds at their customers' expense during the clearing process, have generated particular concerns about cheque clearing arrangements in Australia...'⁶⁷

2.62 While banks have denied such claims, they have committed to a timetable to reduce cheque clearance from five to three days (that is, 48 hours after the day on which the cheque is deposited). Testing of the new system will commence on 1 July 1998 and it is expected to be implemented in July 1999. While the RBA noted that all agree it is unfortunate that the banks did not start this process sooner, it believes that there is now a commitment in place to achieve a system which will be close to world best practice. It also said that it is unlikely that the current timetable could be reduced because of the complexity of arranging the electronic linkages between the banks and the need to extensively test those links.⁶⁸

2.63 The other important development in the payments system is the introduction of the real time gross settlement system which allows large payments to be settled individually in 'real time'. The RBA believes this will significantly reduce inter-bank settlement risk.⁶⁹ This system was expected to commence operating in April this year, but was delayed until June after testing revealed unexpected performance problems in the system.⁷⁰

2.64 The Committee will seek progress reports on these developments at its May hearing with the RBA.

65 Evidence pp 55-57.

66 Committee recommendation: That the Australian Prudential Regulation Authority be required to appear before the House of Representatives Standing Committee on Financial Institutions and Public Administration at a public hearing once a year to report on prudential supervision of the financial services industry. in House of Representatives Standing Committee on Financial Institutions and Public Administration. September 1997. *Reviews of the 1995-96 annual reports of the Reserve Bank of Australia, Australian Securities Commission and the Insurance and Superannuation Commission*. Canberra, AGPS, p 17.

67 Australian Payments System Council. September 1995. *The cheque clearing cycle*. Sydney, Australian Payments System Council, p 1. (Australian Payments System Council Information Paper).

68 Evidence p 54.

69 Evidence p 57.

70 Reserve Bank of Australia. *RTGS industry testing bulletin*, 4 February 1998, Issue 16.

Bank lending and bank margins⁷¹

2.65 Bank lending and bank margins, particularly in relation to small business, is a topic which is of particular interest to this Committee with requests for work by the RBA on this topic being made by this Committee last year⁷² and by its predecessor Committee in August 1994.

2.66 The RBA argued that while progress has been slow, competitive pressures have been gradually working their way into banks' margins. It said progress has been greatest in the margin on standard variable housing loans which fell from a level which was high by international standards to one which is about average with the biggest contributing development being the entry of mortgage originators into the housing market⁷³ in 1992 (see Table 2.1).

Table 2.1: Margin over the Cash Rate (percentage points)

	Small business variable- rate loans	Large business variable- rate loans	Standard variable housing loans	Credit cards (interest free period; annual fee)	Personal instalment loans (variable secured)	Personal instalment loans (variable unsecured)
Mar 95	5.1	3.3	3.0	9.2	3.9	5.4
Jun 95	5.0	3.1	3.0	9.2	3.9	5.4
Sep 95	5.0	3.1	3.0	9.2	3.9	5.4
Dec 95	5.0	3.1	3.0	9.2	3.8	5.5
Mar 96	5.1	3.1	3.0	9.2	4.0	6.0
Jun 96	5.1	3.1	2.3	9.2	3.6	6.0
Sep 96	5.0	3.2	2.3	9.7	3.9	6.5
Dec 96	5.4	3.5	2.3	10.2	4.4	6.9
Mar 97	4.9	3.4	1.6	10.0	4.0	6.6
Jun 97	5.1	3.6	1.7	10.5	4.1	6.9
Sep 97 (p)	5.1	3.6	1.7	10.3	4.3	7.4

(p) Preliminary

Source: Evidence p S7.

71 Bank margins are defined as the difference between the average rate banks earn on their loans minus the average rate they pay on their deposits (Evidence p 11).

72 Evidence pp S1-S9.

73 Evidence p 11.

2.67 In its submission on small and medium size business lending the RBA reported that: '...there are now signs of growing competition in small business finance...'⁷⁴; 'It seems unlikely that margins on lending to small business will fall to the same extent as those on owner-occupied housing...'⁷⁵; small business lending approvals have picked up in recent months; business surveys of small business indicate finance is not a major concern for small business; and 'Members of the Reserve Bank's Small Business Advisory Panel also report that they are generally content with both the availability of bank lending and current levels of interest rates...'⁷⁶

2.68 The RBA also noted that the 5.1 percentage point Australian margin over the cash rate that applies to small business loans in Australia, is higher than figures in the United States and the United Kingdom.⁷⁷

2.69 In evidence the RBA concluded:

We are now beginning to see hotter competition in lending to small and medium-sized businesses and partly this is the result of the need felt by many banks, particularly the regional ones, to reduce their reliance on the now much less profitable mortgage market...⁷⁸

2.70 The Committee's reading of the RBA's figures is not quite as optimistic as that of the RBA. The Committee would like to see further evidence on lending to small business at its next hearing, particularly given the recent events in Asia.

Approach to bank supervision

2.71 'During 1996/97, the Bank's supervisory emphasis continued to shift towards greater reliance on banks' own risk management systems, provided these systems meet certain objective requirements...'⁷⁹ For example, in January 1997 adjustments to capital adequacy standards which allow banks to use their own risk measurement models to calculate capital requirements for market risk in their trading portfolio etc. Some 10 to 12 banks plan to seek "internal model status" by early 1998.

2.72 The RBA reported that:

...on almost every objective measure you can find of the asset quality of Australian banks at the moment, the position is very strong. The ratio of their impaired assets to their total assets is less than one per cent, which compares with about six per cent five or six years ago...Their direct exposure to the South-East Asian countries is relatively small, so that assessment has not been affected by the events in Asia in the last couple of months.⁸⁰

74 Evidence p S6.

75 Ibid.

76 Evidence p S8.

77 See Evidence p S7.

78 Evidence pp 11-12.

79 *RBA report and financial statements 30 June 1997*, op cit, p 28.

80 Evidence pp 39-40.

2.73 However, the Deputy Governor, Mr Graeme Thompson, noted that the Bank has detected some early signs of declining lending practices by banks and fired an early warning signal about that trend to try to prevent serious problems emerging.⁸¹

2.74 On 25 September, prior to the hearing, the Deputy Governor elaborated that the RBA has detected this with lending to large corporations and there are threats it will spill over to home lending and consumer finance. He reported banks were taking short cuts in home lending, including not properly checking applicants' incomes and a failure to test a borrowers' capacity to keep making repayments if, over the course of the loan, interest rates were to increase. He expects the situation to get tougher as competition intensifies, especially with implementation of the Wallis reforms.⁸²

2.75 However, the Deputy Governor reported that he had been heartened by the number of banks that agreed with that assessment, even though they believe their bank is not involved. He said the Bank would monitor this situation while it still has the supervisory responsibilities.⁸³

2.76 The Committee will follow up this matter with the RBA at the next hearing to see if there has been an improvement resulting from the RBA's actions.

"Year 2000 problem"

2.77 In its annual report the RBA points to the "Year 2000 problem" which arises because computer software and hardware uses only two digits to represent calendar years (for example, 97 for 1997) and will not be able to recognise the change to the new century. The RBA said the consequences of not addressing this problem are that calculations and comparisons will be incorrect, data destroyed, and possible disruption to the financial system.⁸⁴ Estimates of the cost for banks replacing or reprogramming their date dependent computer systems are around \$600 million.⁸⁵

2.78 The RBA advised it had sought assurance from Australian banks that they are giving the "Year 2000 problem" the high priority it warrants. Banks' progress has been sought through a questionnaire.⁸⁶ Preliminary results indicate that the current state of preparation is mixed.⁸⁷ Some commentators suggest that Australia is not as advanced as their United States counterparts which are required to be year 2000 compliant by the end of 1998 to allow thorough testing.⁸⁸

81 Evidence p 40.

82 Thompson, GJ, Deputy Governor, RBA. Banking: the changing scene. *First Pacific Stockbrokers Australasian Banking Conference, Melbourne, 25 September 1997.* in *RBA Bulletin, October 1997.* Sydney, RBA, pp 32-37.

83 Evidence p 40.

84 *RBA report and financial statements 30 June 1996-97*, op cit, p 31.

85 Thompson, GJ. Deputy Governor, RBA. More on risks in banking. *Paper presented to the Australian Institute of Banking and Finance Inc, NSW State Committee, Sydney, 28 October 1997*, p 2.

86 *RBA report and financial statements 30 June 1996-97*, op cit, p 31.

87 Thompson, GJ, op cit, 9p.

88 Wood, C. Reserve cuts the apron strings. *Business Review Weekly*, 28 July 1997, pp 88-91.

2.79 In evidence the RBA said banks have:

...made a start on fixing the problem but they have a lot of work to do. Our assessment from our survey responses is that there is still sufficient time, given where they are, to sort out the solutions to the problem before the date...

We would be happier if they were moving a bit faster, but by and large they have adopted the generally endorsed target of having the systems year 2000 compliant by the end of 1998. That allows a little time for slippage if they are not successful in meeting that [date]...

It is in their commercial interests to sort out the problem.⁸⁹

2.80 The Committee, like the RBA, will continue to monitor this problem over the next 18 months or so.

Central bank cooperation

2.81 Through the forum of central bankers - the Executive Meeting of East Asia and Pacific Central Banks (EMEAP) - the RBA cooperates with central banks and monetary authorities in eleven countries. Membership comprises Australia, People's Republic of China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand. Amongst the achievements of EMEAP listed by the RBA was EMEAP's contribution towards helping the Thai support package to be reached quickly.⁹⁰ The Committee commends the RBA for its contribution to this forum and encourages its continued participation.

David Hawker MP
Chairman
5 March 1998

89 Evidence p 48.

90 Evidence p 32; and for additional information see *RBA report and financial statements 30 June 1997*, op cit, p 55.

APPENDIX 1

LIST OF SUBMISSIONS

- 1 Reserve Bank of Australia

APPENDIX 2

LIST OF HEARINGS AND WITNESSES

Sydney, Thursday 6 November 1997

Reserve Bank of Australia

Dr Stephen Grenville, Deputy Governor

Mr Ian Macfarlane, Governor

Mr Graeme Thompson, Deputy Governor

PRIVATE BRIEFINGS

Thursday, 23 October 1997

Mr Barry Hughes, Chief Economist, CS First Boston

Thursday, 30 October 1997

Mr Ivan Colhoun, Director and Senior Economist, Deutsche Morgan Grenfell
(Australia)

COMMITTEE'S REVIEWS OF ANNUAL REPORTS

38TH PARLIAMENT

Review of the Australian Competition and Consumer Commission annual report 1996-97
(Tabled 9 March 1998)

Reviews of the 1995-96 annual reports of the Reserve Bank of Australia, Australian Securities Commission and the Insurance and Superannuation Commission
(Tabled 29 September 1997)

Review of the Australian Competition and Consumer Commission's 1995-96 annual report
(Tabled 23 June 1997)

Forthcoming report

Review of the National Competition Council annual report 1996-97

37TH PARLIAMENT

Review of the Reserve Bank of Australia's 1993-94 annual report and the Insurance and Superannuation Commission's 1993-94 annual report
(Tabled 25 September 1995)

Review of the Reserve Bank of Australia's 1992-93 annual report
(Tabled 29 August 1994)

