



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

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

June 1998



The Parliament of the Commonwealth of Australia

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## FOREWORD

This is the final report of the Committee's review of the Reserve Bank of Australia's 1996-97 annual report and the Bank's appearance before the Committee to discuss the conduct of monetary policy over the six months to May 1998 as outlined in the Bank's *Semi-annual statement on monetary policy, May 1998*. The Committee's report updates and compliments its interim report which examined the six months to November 1997.

The report comes at a critical and interesting stage in the economic cycle - some ten months after the fifth cut in interest rates - and as economic and political change in the Asian region surpass previous expectations. The Bank provided valuable information on its current thinking on the crisis and its impact on the Australian economy. This external shock remains the major uncertainty for a domestic economy with such sound fundamentals.

The Committee and Bank's meetings continue to enhance the transparency and accountability of the Bank's activities.

This public accountability process continues to be very well received and supported. Like previous meetings, the May hearing attracted considerable interest from the community, financial sector and the media. Public awareness and understanding of the Bank's activities appear to have expanded and I am pleased that the parliamentary committee system has been able to assist.

The Committee's task 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. We appreciate the detailed information they provided both at the hearing and in the May 1998 semi-annual statement.

The Committee also appreciates the briefings it received from Mr Ivan Colhoun, Director and Chief Economist, Deutsche Morgan Grenfell (Australia) and Mr Barry Hughes, Chief Economist, CS First Boston just prior to the hearing. It has been very useful for the Committee to consider some of the significant issues from different perspectives.

Finally, I thank all the members of the Financial Institutions and Public Administration Committee for their professional approach to the public hearing and for their contributions to this 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)  
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Mrs C A Gallus, MP  
Mr J B Hockey, MP  
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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 D Richardson

**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 report and financial statements 30 June 1997* was tabled in the House of Representatives on 1 September 1997.



## **ACRONYMS AND ABBREVIATIONS**

ACTU	Australian Council of Trade Unions
AFIC	Australian Financial Institutions Commission
AIM	Australian Institute of Management
APRA	Australian Prudential Regulation Authority
AWOTE	Average weekly ordinary-time earnings
CED	Cullen Egan and Dell
Cwlth	Commonwealth
EEH	Australian Bureau of Statistics survey of Employee Earnings and Hours
EMEAP	Executive Meeting of East Asian and Pacific central banks
IMF	International Monetary Fund
ISC	Insurance and Superannuation Commission
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
RBA	Reserve Bank of Australia
RPC	Remuneration Planning Corporation
RTGS	Real time gross settlement system



# CHAPTER ONE

## INTRODUCTION

### Background

1.1 In August 1996 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*<sup>1</sup> which set out a common understanding between the Governor and the Government on key aspects of Australia's monetary policy framework. These arrangements extended and more formalised the Reserve Bank of Australia's (RBA's) accountability 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. Economic commentary is now mainly found in the RBA's two quarterly and two semi-annual statements and in articles in the Bank's monthly *Bulletin*. The Bank's annual report now focuses on the operations of the Bank. Further, it was agreed that the Governor would appear before the House of Representatives Standing Committee on Financial Institutions and Public Administration twice each year to report on the conduct of monetary policy.

1.2 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.

1.3 These biannual appearances built on five years of meetings with the Financial Institutions Committee, or its predecessor committees, which reviewed the annual reports of the 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 make (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.

1.6 The Committee has held three meetings with the RBA under the new arrangements, and both groups agree that the arrangements are working well with considerable public interest in the proceedings.<sup>2</sup>

1.7 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).

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

2 Evidence pp 3 and 60.

## Scope and conduct of the review

1.8 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 and May 1998 semi-annual statements.<sup>3</sup>

1.9 On 23 March 1998 the Committee tabled an interim report<sup>4</sup> which discussed matters arising from the public hearing on 6 November 1997, the November semi-annual statement and RBA's annual report.

1.10 This current report builds on the interim report but focuses on the May 1998 semi-annual statement and the 7 May 1998 public hearing which was held in Melbourne. Details of that hearing are set out at Appendix 2. A copy of the May 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<sup>5</sup>. Copies of the May statement are available from the Reserve Bank and on its internet site<sup>6</sup>.

1.11 The interim and final reports together form the Committee's final deliberations of the activities of the Reserve Bank over the past year or so.

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 five submissions to the review, two of which address small business lending, a third addressing executive earnings and wages growth and two providing answers to additional questions submitted by the Committee. The later dealt mainly with the operations of the Bank and prudential matters (see Appendix 1).<sup>7</sup>

1.14 In the lead up to its May hearing with the RBA, the Committee held private briefings with two leading economists from the financial sector - Mr Ivan Colhoun, Director and Chief Economist, Deutsche Morgan Grenfell (Australia) and Mr Barry Hughes, Chief Economist, CS First Boston. Those briefings presented alternate views on some aspects of monetary policy, the Australian economy and the region thereby suggesting some particular matters that might be raised with the RBA.

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3 *Reserve Bank of Australia report and financial statements 30 June 1997*, op cit, 91p; Reserve Bank of Australia. 1997. *Semi-annual statement on monetary policy, November 1997*. Sydney, RBA, 40p; and Reserve Bank of Australia. 1998. *Semi-annual statement on monetary policy, May 1998*. Sydney, RBA, 49p.

4 House of Representatives Standing Committee on Financial Institutions and Public Administration. March 1998. *Review of the Reserve Bank of Australia annual report 1996-97: Interim report*. Canberra, House of Representatives Printing Service, xiii 25p.

5 URL <http://www.aph.gov.au/hansard/reps/commtee/r1712.pdf>

6 URL [http://www.rba.gov.au/bulletin/bu\\_may98/Semi\\_Annual\\_0598.pdf](http://www.rba.gov.au/bulletin/bu_may98/Semi_Annual_0598.pdf)

7 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 some submissions are also available on the Committee's internet site.



1.15 In undertaking its review the Committee examined monetary policy, prudential matters and some other aspects of the operation of the Bank and this report focuses on all three. In addressing monetary policy the Committee has not repeated the detail of the RBA's views as set out in the May 1998 semi-annual statement, rather it has highlighted a number of significant matters that were raised at the public hearing, some of which are also set out in the semi-annual statement.



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## CHAPTER TWO

# CONDUCT OF MONETARY POLICY AND SURVEILLANCE OF THE FINANCIAL SYSTEM

2.1 At the 7 May 1998 hearing the Governor again 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. This reflected the concluding statement of the agreement between the Treasurer and the Governor in their *Statement on the conduct of monetary policy* 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.'<sup>1</sup>

### Conduct of monetary policy

#### Review of November 1997 expectations

2.2 In summary at the November 1997 hearing the Reserve Bank of Australia (RBA) expected GDP to grow at about 4%, inflation would remain below 2% for a while but tend to pickup through 1998, and there was a good chance unemployment would decline.<sup>2</sup>

2.3 The Governor noted that he had '...said very little about the current account and the balance of payments as the outlook for Asia was still very unclear...'<sup>3</sup>

2.4 On the basis of all available data (all four quarters for 1997) GDP grew by 3.6% over 1997 and non-farm GDP by 3.8% both slightly less than the RBA expected; underlying inflation has been 1.5% over the last 12 months; and there was a reduction of about half a per cent or so in the unemployment rate across the past 12 months - down from 8.75% in the first half of 1997 to 8.2% to 8.1% in the past few months - making the labour market better than the RBA had expected when discussing this matter in November. The RBA attributed this unemployment rate to a combination of good growth and moderate outcomes on wages.<sup>4</sup>

2.5 The Governor said he was reasonably comfortable with the Bank's earlier assessment except regarding the full extent of the Asian slow down which now requires a bigger external and contractionary effect to be factored in.<sup>5</sup> The Committee obviously agrees but notes that a number of economic commentators had been predicting a greater impact of the Asian crisis back in November 1997.

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

2 Evidence p 61.

3 Evidence p 61.

4 Evidence pp 61-62.

5 Evidence p 62.

## Prospects for 1998

2.6 As a result of the international environment facing the Australian economy the RBA now expects growth through 1998 to be somewhat lower, of the order of 3%; inflation is still expected to rise over the next 12 months (largely due to increasing import prices) and go into the 2%-3% range but not in an alarming way - Australia is past the low point in the inflation cycle; and the unemployment rate is expected to flatten out.<sup>6</sup>

2.7 The RBA stated that demutualisation of AMP could add up to about three tenths of a percentage point to GDP with most of this effect in the current year.<sup>7</sup> In its May statement it also reported that '...The Telstra privatisation probably had a small positive effect on consumer demand in the December 1997 and March 1998 quarters...'<sup>8</sup>

2.8 The preliminary unemployment rate for April 1998 was 7.9%, the best figure in eight years. The RBA described this as a relief because the March quarter figures were weak and disappointing given GDP at 3.75% through 1997 (employment usually lags GDP growth). It said taking the April figure into account, when averaged, employment growth is more in line with the economic growth experienced in 1997. Reinforcing this view has been the rise in vacancy levels. The RBA considers this is an important figure because it is not just the result of a change in the participation rate.<sup>9</sup>

2.9 The Bank said that in the medium term there is still more work to be done on unemployment.<sup>10</sup>

2.10 In its May statement when discussing labour costs, the RBA reported that average weekly ordinary-time earnings (AWOTE) increased by 3.9% over the past year. Despite marked fluctuations in both the quarterly and annual figures, in annual terms the rate of increase has come down slightly from the 4.3% rate of a year ago. Over the six months to February, the annualised rate of increase was 3.3%. In broad terms, private-sector and economy-wide wages are probably now growing at a bit under 4%; there has been an easing in the pace of negotiated wage increases recently from enterprise bargaining, especially in the private sector; the recent Safety-Net Review represents a slightly larger than average increase than was awarded the previous year; and the results of the Cullen Egan and Dell survey indicate executive salaries continue to grow at annual rates of around 6% - the same rate that has prevailed for the past two years.<sup>11</sup>

2.11 On inflation expectations, the situation hasn't changed much since the RBA's response at the hearing in November. While expectations have come down a bit, the RBA would like a rate of about 2.5%, the actual level is higher, about 3.4%.<sup>12</sup>

2.12 Obviously, the current account of the balance of payments is expected to widen. The Governor stressed that '...This is not a sign of economic policy failure and I trust markets will

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6 Evidence p 62.

7 Evidence p 86 and Reserve Bank of Australia. 1998. *Semi-annual statement on monetary policy, May 1998*. Sydney, RBA, p 19.

8 *Semi-annual statement on monetary policy, May 1998*, op cit, p 18.

9 Evidence pp 76-77.

10 Evidence p 93.

11 *Semi-annual statement on monetary policy, May 1998*, op cit, pp 43-45.

12 Evidence pp 29 and 79-80.

treat it accordingly.<sup>13</sup> The Committee notes that the Governor in making decisions about monetary policy should have regard to international market confidence in the Australian currency and economy at large.

2.13 The Committee notes there are a range of views regarding the RBA's confidence that a widening of the current account deficit towards 6% of the GDP will not restrain the growth of the Australian economy and other aspects of domestic policy.

2.14 Comparisons were made of the current situation with that in 1985-86 when there was a loss of confidence in the Australian dollar and a massive capital outflow and the somewhat similar situation facing Thailand in the middle of 1997.<sup>14</sup>

2.15 On this occasion the Bank said '...the widening of the current account deficit is not the result of excessive growth in domestic demand, nor is it the result of a decline in competitiveness because of high Australian inflation, nor is it the counterpart to a large budget deficit...'<sup>15</sup> Accordingly, the RBA does not consider the classic response (as made in 1985-86) of tightening monetary policy - increasing interest rates - and tightening fiscal policy, is warranted on this occasion.<sup>16</sup>

2.16 Rather, the decline in the current account is the result of the external shock. The RBA said imports are probably slowing from their very high growth rate in the second half of last year and during 1998 it still expects them to grow by a few percentage points per annum faster than domestic demand. Exports, on the other hand, cannot hope to keep up with last year's pace of 8.5% and a small positive figure is the most Australia can hope for. The prices of Australian commodity exports have fallen by 9% over the past year when measured in terms of a neutral basket of currencies, but at the same time the Australian dollar has fallen against that neutral basket. Commodity prices in Australian dollars have gone up slightly. The foreign exchange market has adjusted to shield the export sector.<sup>17</sup> In January and May 1998 the Bank undertook some modest intervention in the market to restore orderly conditions.

2.17 At the same time the Governor believes the international markets remain confident in the soundness of the Australian economy and Australian economic policy. He stressed that this is critical for without it big costly adjustments will have to be made.<sup>18</sup>

2.18 The Bank expects the current account deficit in 1998 to be about 5.5% of GDP. However, the Governor noted '...if you look at the cyclical behaviour of the current account over the last two decades, you could not rule out it touching six per cent for a time.'<sup>19</sup>

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13 Evidence p 62.

14 Evidence pp 70-71 and 82-83.

15 Evidence p 63.

16 Evidence pp 70 and 83.

17 Evidence p 63.

18 Evidence p 71.

19 Evidence p 63.

2.19 The Committee raised the issue that since on four occasions in the past 20 years where the current account deficit in Australia had risen above 6% of GDP, normally the point at which international markets lose confidence in the Australian fundamentals, interest rates had risen. The Governor said that on those previous occasions there was present one or more of the aforementioned serious policy imbalances (see paragraph 2.15) that caused a tightening of monetary policy. The Governor argued that those imbalances are not present on this occasion.<sup>20</sup>

2.20 The RBA noted there are enormous variations in the way the exchange rate has behaved against different currencies. It said in the current extreme circumstances where the Australian dollar has appreciated massively against a few currencies and gone down against the rest, the trade-weighted index (TWI) is a misleading indicator of changes in Australia's competitive position. Other measures of competitiveness of Australia exporters and importers give a better indication, for example the TWI weighted by imports which is actually down by a further 5%-6% more than the full TWI indicates, looking at export competitors in international markets, and looking at the Australian dollar against major G7 currencies.<sup>21</sup>

2.21 Questions were also asked about the failure to improve national savings levels. The Governor pointed out that successive Australian governments have attempted to address this problem but it is extremely difficult to do so.<sup>22</sup> The Committee will follow this matter up at the next hearing.

### **Asia and the rest of the world**

2.22 At the May hearing the RBA reiterated the comments it made on the causes of the Asian crisis at the last hearing and in several speeches since then.<sup>23</sup> It acknowledged that:

...The crisis has spread further than was first thought likely. It is resulting in larger falls in output and employment in the countries concerned, and finally it has been compounded by the relapse of the biggest Asian economy, Japan, into recession...<sup>24</sup>

2.23 It noted that at the core of the problem is the very rapid adjustments the countries involved have had to make to their external positions to stop their exchange rates from falling below the extremely low levels they reached in late 1997. To achieve this they had to return their current accounts to surplus with tight policies involving very large falls in domestic

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20 Evidence pp 82-83.

21 Evidence pp 75-76.

22 Evidence pp 83-84.

23 Evidence pp 6 and 64; and examples of speeches include: Macfarlane, IJ, Governor RBA. Some thoughts on Australia's position in light of recent events in Asia. Paper presented to *Australian Stock Exchange, Australian Institute of Company Directors and The Institute of Australia, Bull and Bear Luncheon, Brisbane, 26 March 1998*. in: *RBA Bulletin, April 1998*. Sydney, RBA, pp 1-8. and Grenville, SA, Deputy Governor RBA. The Asian economic crisis. *Australian Business Economists and the Economic Society of Australia, (NSW Branch), Sydney, 12 March 1998*. in: *RBA Bulletin, April 1998*. Sydney, RBA, pp 9-20.

24 Evidence p 64.

demand and imports (for the three countries in International Monetary Fund (IMF) programs, imports have fallen by 30%-40% over the last six months).<sup>25</sup>

2.24 The major uncertainty is Japan<sup>26</sup> - Australia's largest market. The Bank elaborated on the Japanese situation noting: the Japanese economy has been flat for six years which seems to be more than a cycle; some eight major fiscal packages since late 1992 which were not quite as large as they seemed and in lots of ways were simply bringing forward expenditure; IMF forecasts of zero GDP growth for Japan in the current year, though small positives in growth for the next year; and redressing the Japanese situation depends on whether Japan can address the structural issues such as an ageing population, an economy which has traditionally had a lot of government interference, a lot of interrelationships between government and business, and a financial sector not helpful to the process of business and intermediation. The RBA said it found the Japanese situation very disappointing. Whether Japan can get back to faster rates of growth really depends on the extent of the structural change.<sup>27</sup>

2.25 It noted that the interesting contrast at the moment is a dichotomy between success in the United States (US) and the apparent failure in Japan.<sup>28</sup>

2.26 The Bank provided further details on the IMF support packages.<sup>29</sup> In the May statement it set the packages within the context of the IMF's wider financing activities.<sup>30</sup> The Bank also pointed out that 'One of the key functions of the IMF is to provide financial assistance to member countries experiencing balance of payments difficulties...'<sup>31</sup>

2.27 The RBA stressed that it has a very high regard for the important role that the IMF plays in the international financial system and it expects that the IMF will probably have a bigger role in the future.<sup>32</sup>

2.28 It said 'Our only reservation really has been how stringent and how broad some of the conditions have become over very recent years...'<sup>33</sup> Now if a country goes to the IMF it is not just fiscal, monetary and financial system stability conditions that are imposed, there is a much wider list. It went on to say that while many of the things on the IMF's wider list (eg rules about corporate governance, conditions on the break up of monopolies and cartels, conditions on opening up the domestic economy to trade etc) are quite good,

...they are so wide ranging that it makes it very difficult for a country to reach a quick agreement because they are being asked to transform the whole economy rather than just the traditional policy levers that they were expecting, so it makes it a very slow and tortuous process for countries to reach agreement.

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25 Evidence p 64.

26 Evidence p 69 and *Semi-annual statement on monetary policy, May 1998*, op cit, p 1.

27 Evidence pp 72-75.

28 Evidence pp 73-74.

29 Evidence p 86.

30 *Semi-annual statement on monetary policy, May 1998*, op cit, pp 4-6.

31 *Semi-annual statement on monetary policy, May 1998*, op cit, p 4.

32 Evidence p 87.

33 Evidence p 87.

The problem is that quickness or speed is important...Some of the things that they have to sign up to are things that took us decades or more to reach agreement on here.<sup>34</sup>

2.29 Specifically in relation to Indonesia the RBA said, it is important to recognise that what had happened to date had been a disaster and the seriousness of the likely social and economic costs in Indonesia and how they were getting worse. It described Indonesia's situation as unprecedented - its real exchange rate collapsed so quickly. It noted that the IMF package for Indonesia was very difficult to reach agreement on quickly, since very wide-ranging fundamental reforms were involved, and while the package was being negotiated the rupiah fell from 3000 rupiah to the dollar to 12000 rupiah to the dollar.<sup>35</sup>

2.30 To overcome its capital account problem and the lack of confidence on international markets, Indonesia needs to develop a modern financial system with proper prudential supervision. Equally, it is in Australia's best interest to see further reduction in tariffs and import quotas in Indonesia. In evidence the Governor pointed to the way in which economic liberalisation '...took decades to occur in this country, took decades to occur in a number of other countries...'<sup>36</sup> It is valid to point out, however, that Australia has never had the type of difficulties that plague Indonesian markets.

2.31 The RBA advised that while some countries were urging the IMF to be tougher regarding the Indonesian packages, the Australian Government sought to be a counterweight to this, and tried to urge a bit of flexibility. It did this from about February onwards and encouraged other countries to do the same. The RBA reported that during Michel Camdessus's (Head of the IMF) recent visit to Australia, Mr Camdessus said the IMF appreciated the intervention by the Australian Government.<sup>37</sup> The Committee supports the Government's stance.

2.32 At present the situation in Indonesia is changing almost on a daily basis - obviously, the Committee will monitor events and discuss these matters with the Bank at the November hearing.

2.33 On the issue of the US having inordinate control over the IMF, the Bank replied that '...the US is the one power that can exert leadership, and in any international forum the US will be the strongest member.'<sup>38</sup>

### **Impact of the Asian crisis on Australia**

2.34 The Bank in no way sought to downplay the effects of Asia, noting that it was the first significant identifiable external shock for a long time - since OPEC II in 1979 - though OPEC was on a much bigger scale affecting the whole OECD area more evenly.<sup>39</sup>

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34 Evidence p 87.

35 Evidence pp 87-89.

36 Evidence p 90.

37 Evidence p 88.

38 Evidence p 90.

39 Evidence p 63.



2.35 Rather it stated '...To the contrary, the biggest difference between the way we view our immediate future today and the way we viewed it a year ago is clearly the external shock we have received from Asia...'<sup>40</sup>

2.36 It pointed to Australia's greater exposure to the Asian crisis than other OECD countries, except Korea and Japan, which are part of the crisis. The Bank said it has always been very conscious of Australia's vulnerability to a sharp contraction in Asia but the guiding policy principle has been that the economic problem could be minimised by prompt action. This fact lay behind Australia's quick response to the Thai crisis.<sup>41</sup>

2.37 'Australia's exports to these countries appear to have fallen, roughly in line with their falling imports...'<sup>42</sup> The effects on trade flows date from December 1997 - there was a very sharp turnaround in the current account towards deficit which has continued in the first three months this year.<sup>43</sup>

2.38 In fact, the Bank said the immediate effects of the crisis were not exactly what it expected. It said it initially thought the immediate impact would be felt on financial prices - exchange rate, interest rates, share markets, etc, with the actual economic effects coming through very slowly and the effects getting larger through 1998. However, the economic effects are coming through faster than it thought, with the current account deteriorating very quickly and more quickly and sharply than its forecasts. It noted that the deterioration is due to both weak exports and extremely strong imports.<sup>44</sup>

2.39 On a positive note, the Bank said it expects the Asian economies' falls in imports to flatten out, because those countries already have moved their current accounts into surplus.<sup>45</sup>

### **How has Australia coped?**

2.40 The Bank believes that:

To date we have coped quite well with this situation largely because we were in good shape going into it, with strong domestic demand and low inflation...due in part to the fact that we had taken expansionary monetary policy action between July 1996 and July 1997...and our financial markets have behaved very sensibly...our exchange rate has depreciated against the US dollar and against other major currencies, but this is an understandable market reaction to the deterioration in our international trading position. Apart from a minor panic in January, the whole process has been very orderly.<sup>46</sup>

2.41 The Bank also said the bond market has performed very well, with both international and domestic investors drawing a distinction between Australia and Asia.<sup>47</sup>

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40 Evidence p 63.

41 Evidence p 64.

42 Evidence p 64.

43 Evidence pp 64-65.

44 Evidence pp 68-69.

45 Evidence p 69.

46 Evidence p 65.

47 Evidence p 65.

2.42 The Governor said the implication for monetary policy is that it makes it more difficult. For future policy, Asia will be the major influence.<sup>48</sup>

2.43 At the November hearing the Governor noted that interest rates were almost as low as any of us can remember in our working lives.<sup>49</sup> In the last two and a half years interest rates have been reduced five times by half a percentage point on each occasion, down from 7% to 5%. Since January 1990 interest rates have fallen from 17%-17.5% down to 5%. Details of these changes are shown by Table 2.1.

2.44 Further information was sought by the Committee on aspects of small business finance, a topic which the Committee had pursued over a number of hearings.<sup>50</sup> In a submission the RBA advised that banks have started cutting interest rates on mainstream lending products for small business with the small business variable-rate now concentrated around 7%, down from 8.75% in December 1997 and 11.25% in June 1996.<sup>51</sup> The impact and scope of the change in small business indicator rates from June 1996 to May 1998 is shown by Table 2.2. This is a good outcome.

2.45 Interest rate margins have changed significantly. The average rate paid by small business on variable-rate loans has dropped from 5.1 percentage points in March 1995 to 4.4 percentage points in December 1997 (see Table 2.3). The Bank said 'The tentative signs of increased competition in small business finance that were evident six months ago have become clearer in the period since...'<sup>52</sup> The Committee agrees.

2.46 At the hearing, when questioned further on the easing of monetary policy the Governor said '...It is a consideration now. It is something that people are speculating about and it is something that we have thought very seriously about.'<sup>53</sup>

2.47 However, the Governor said the Board considers the present setting in monetary policy is the right one.<sup>54</sup>

2.48 Questions were also raised about the possibility of minor interest rate adjustments in the order of 25 base points, as in the United Kingdom and the US. The Governor acknowledged that it is conceivable. He compared the one percentage point adjustments in the early 1990s when the Bank was working off a very high interest rate base and the Bank needed to move by quite a large amount to have an impact, with the more recent half per cent movements as interest rates became lower (see Table 2.1).<sup>55</sup>

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48 Evidence p 65.

49 Evidence p 20.

50 See House of Representatives Standing Committee on Financial Institutions and Public Administration. March 1998. *Review of the Reserve Bank of Australia annual report 1996-97: Interim report*. Canberra, House of Representatives Printing Service, p 16.

51 Evidence pp S12-S18; and see also for an updated version of the submission *Semi-annual statement on monetary policy, May 1998*, op cit, pp 34-36.

52 Evidence p S12.

53 Evidence p 67.

54 Evidence pp 66 and 68.

55 Evidence p 71.

**Table 2.1** *Reserve Bank of Australia: Monetary policy changes (per cent)\**

<b>Date</b>	<b>Change in cash rate</b>	<b>New cash rate target</b>
23 Jan 1990	-0.50 to -1.00	17.00 to 17.50
15 Feb 1990	-0.50	16.50 to 17.00
4 Apr 1990	-1.00 to -1.50	15.00 to 15.50
2 Aug 1990	-1.00	14.00
15 Oct 1990	-1.00	13.00
18 Dec 1990	-1.00	12.00
4 Apr 1991	-0.50	11.50
16 May 1991	-1.00	10.50
3 Sep 1991	-1.00	9.50
6 Nov 1991	-1.00	8.50
8 Jan 1992	-1.00	7.50
6 May 1992	-1.00	6.50
8 Jul 1992	-0.75	5.75
23 Mar 1993	-0.50	5.25
30 Jul 1993	-0.50	4.75
17 Aug 1994	+0.75	5.50
24 Oct 1994	+1.00	6.50
14 Dec 1994	+1.00	7.50
31 Jul 1996	-0.50	7.00
6 Nov 1996	-0.50	6.50
11 Dec 1996	-0.50	6.00
23 May 1997	-0.50	5.50
30 Jul 1997	-0.50	5.00

Note \* Monetary policy decisions are expressed in terms of a target for the cash rate, which is the overnight money market interest rate.

Source: *Reserve Bank of Australia Bulletin, May 1998*. Sydney, RBA, p S2.

**Table 2.2** *Small business indicator rates<sup>(a)</sup> (per cent)*

		May 1998	December 1997	June 1996
<b>Overdraft:</b>				
Secured by residential property <sup>(b)</sup>	range	6.95 - 7.20	6.80 - 7.70	n.a.
	average	7.1	7.2	n.a.
Other <sup>(c)</sup>	range	6.95 - 8.75	8.75 - 8.95	11.25
	average	7.7	8.8	11.25
<b>Term:</b>				
Secured by residential property <sup>(d)</sup>	range	6.80 - 6.99	6.80 - 7.15	n.a.
	average	6.9	7.0	n.a.
Other <sup>(c)</sup>	range	6.95 - 8.75	6.99 - 8.95	9.45 - 11.25
	average	7.7	8.8	11.0

(a) Major banks.

(b) Most banks do not apply a margin to overdrafts secured by residential property, although one does.

(c) Customer risk margins apply to these products.

(d) Since March 1997, banks have not applied a customer risk margin to term loans secured by residential property.

Source: Reserve Bank of Australia. 1998. *Semi-annual statement on monetary policy, May 1998*. Sydney, RBA, p 34.

**Table 2.3** *Interest rate margins<sup>(a)</sup> (percentage points)*

	Over cash rate			Over swap rate	
	Small business indicator rates:			Average rate	
	Residential-secured Term loans	Overdraft	Other overdraft	Paid by small business on variable-rate loans	
Mar 95			3.60	5.1	1.6
June 95			3.60	5.0	1.2
Sep 95			3.60	5.0	1.6
Dec 95			3.65	5.0	1.8
Mar 96			3.75	5.1	1.4
June 96			3.75	5.1	1.6
Sep 96			3.75	5.0	1.8
Dec 96			4.25	5.4	1.9
Mar 97	1.9	2.5	3.75	4.9	1.5
June 97	2.0	2.3	4.00	5.1	1.6
Sep 97	2.0	2.2	3.80	4.6	1.5
Dec 97	2.0	2.2	3.80	4.4	1.6
Mar 98	2.0	2.2	3.80	n.a.	1.5
May 98	1.9	2.1	2.70	n.a.	1.4

(a) Margins are based on average indicator rates charged by major banks.

Source: Reserve Bank of Australia. 1998. *Semi-annual statement on monetary policy, May 1998*. Sydney, RBA, p 35.

2.49 There has been speculation recently on the impact of an increase in interest rates in the US for Australia. In response the Bank said that if the Federal Reserve increased interest rates successfully in the US (ie no panic ensued, it were simply a small shot across the bow for the US economy, maybe a small fall in Wall Street) he believed Australia would take that in its stride. It said there would be a widening of the interest differential between the US and Australia so there may be some minor impact on the exchange rate but it would not necessarily have any implications for the RBA in its conduct of monetary policy. While not expecting a collapse of Wall Street etc, the Governor said he would have to revise his answer if such a scenario arose.<sup>56</sup>

2.50 While the RBA agreed that the cyclical development between the US and Australian economies is very close, it said Australia does not totally follow US monetary policy. For example this was demonstrated in 1997 when Australia put interest rates down to the US level but then put the cash rate at half a percentage point below the US Fed funds rate. The RBA also suggested that at present the link is weakened because Australia is receiving the Asian external shock to a greater extent than the US.<sup>57</sup>

2.51 The Governor also clarified comments he recently had made on the US stock market, stating that 'It is true that I did say that the stock market was grossly overvalued by all conventional measures of valuation...But I had no desire whatsoever to weigh into that debate...'<sup>58</sup> He explained that the context in which the comment was made was in emphasising the importance of considering economic history. Nonetheless, the Committee notes the careful choice of words used by the Governor.

### **Labour costs**

2.52 At the last hearing and in its interim report the Committee asked the RBA to calculate the contribution of executive salaries to total wages growth.<sup>59</sup> This matter is of interest because of the persistent high rates of growth in various measures of executive earnings.

2.53 The Governor advised that the task was very difficult and the results not much more than to survey the attempts that others had made. He said the result depends on the definition of executive.<sup>60</sup> The scope of definitions and the consequent estimates of the number of people classified as executives is shown by Table 2.4.

2.54 In its submission the RBA stated that following calculation of the estimate of executive share of employment and wages and salaries, the direct contribution that executive earnings make to aggregate wages growth can be identified as simply that share of income times the prevailing growth in executive wage rates. (This assumes executive wage rates are presently growing at an annual rate of 6% in line with the Cullen Egan and Dell base pay series.)<sup>61</sup>

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56 Evidence p 78.

57 Evidence p 85.

58 Evidence p 85.

59 Evidence p 44 and House of Representatives Standing Committee on Financial Institutions and Public Administration, op cit, p 8.

60 Evidence p 97 and see Evidence pp S19-S23.

61 Evidence pp S21-S23.

2.55 A summary of the various surveys estimates of executive salary contributions to aggregate wages growth is at Table 2.5.

2.56 Given rising community interest in this issue the Committee will continue to monitor developments.

2.57 In its interim report the Committee also recommended that the RBA 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.<sup>62</sup>

2.58 At the hearing the RBA advised that it does not have a firm policy on whether it would make any public comment on those claims prior to their adjudication by the Australian Industrial Relations Commission, but it is probable that it would not. It said of the two Safety-Net Wage Reviews that it did make a comment on the first because it felt the combination of circumstances at the time (ie aggregate wages were still going up, enterprises bargains were still going up, AWOTE was still going up, the outcome of the aggregate level for wages was still very uncertain, and the Australian Council of Trade Unions (ACTU) claim was a very high one) there was a possibility of wages getting out of control. In the more recent case the RBA did not comment, because the wages situation was not of as great concern.<sup>63</sup>

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62 House of Representatives Standing Committee on Financial Institutions and Public Administration, op cit, p 8.

63 Evidence pp 98-99.

**Table 2.4**      *Numbers of executives*

<b>Definition</b>	<b>Used by</b>	<b>Implied number</b>	<b>Implied share of wage and salary earners <sup>(a)</sup> (per cent)</b>
Answers to chief executive/board	CED	< 11,000 <sup>(b)</sup>	< 0.2
Titled as executive or general manager	AIM	10,900 <sup>(b)</sup>	0.2
Earns \$100,000 or more from <i>wage income</i>	RPC	7,700 <sup>(c)</sup>	0.1
Earns \$100,000 or more from <i>ordinary-time wages</i>	Cwlth	11,100 <sup>(d)</sup>	0.2
Earns \$100,000 or more on <i>group certificate</i>	ACTU	75,000 <sup>(e)</sup>	1.2

- Notes: (a) As a share of wage and salary earners in corresponding period to estimate of executive numbers.  
 (b) Inferred by matching descriptions of executives to positions in the ABS survey of Employee Earnings and Hours (EEH), May 1996.  
 (c) As surveyed in November 1997.  
 (d) The Commonwealth uses unpublished EEH data (May 1996) to identify the share of employees in each occupation who earned more than \$100,000 per year and multiplied this by the corresponding number of full-time employees aged 20 years and above.  
 (e) From Australian Taxation Office *Taxation Statistics 1994-95*. Using the more recent *Taxation Statistics 1995-96*, this number would be higher.

Source: Evidence p S20.

**Table 2.5**      *Executive salaries contributions to aggregate wages growth*

<b>Source</b>	<b>Share of income (per cent)</b>	<b>Contribution to aggregate wages growth (percentage points)</b>
CED	< 0.6	0.04
RPC	0.6	0.04
AIM	0.5	0.03
Commonwealth	0.8	0.05
ACTU	6	0.36

Source: Evidence p S23.

## Surveillance of the financial system

### Implementation of the Wallis reforms

2.59 The *Australian Prudential Regulation Authority Bill 1998*, omnibus *Financial Sector Reform (Amendments and Transitional Provisions) Bill 1998* and associated bills to give effect to the new regulatory framework for the financial system were introduced into Parliament on 26 March 1998. Many of the structures including the new Australian Prudential Regulation Authority (APRA) are expected to commence operation in early July 1998. Movement of the state based institutions - the building societies, credit unions and friendly societies - to come under the APRA depends on decisions from state and territory parliaments and is not expected to occur until 1 December 1998.

2.60 Work on transition to the new arrangements already has commenced with the chairman, chief executive officers and board members of the various authorities and boards identified.

2.61 The Governor expects the transfer of prudential functions from the RBA to the APRA to proceed smoothly since Graeme Thompson, Deputy Governor, is to be Chief Executive Officer to the APRA, the transfer is occurring at a time when the banking system is in very good shape and most (ie 65 staff) of the people working with the RBA on bank supervision will transfer to the new authority.<sup>64</sup>

2.62 Mr Thompson said in the early stages of the APRA it will be difficult to tell that anything has changed since it is expected that the integration and new premises for the RBA and Insurance and Superannuation Commission staff etc will take place over time.<sup>65</sup>

2.63 Under the new arrangements, 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. The Governor said the RBA will retain a financial systems group, half of which will have an enhanced role in the Payments Policy Department as a result of the Wallis reforms and there will be a smaller Systems Stability Department which will have a more big picture research oriented view trying to work out where it thinks the vulnerabilities are in the financial system.<sup>66</sup>

2.64 The new legislation guides exchange of information between the APRA and the RBA. Other coordination mechanisms include RBA representation on the APRA Board, a Bilateral Committee to coordinate information exchange between the RBA and the APRA, and the new Council of Financial Regulators. There is also a new Financial Sector Advisory Council to facilitate the flow of views between the private sector and government.

2.65 Arrangements for the new regulatory framework appear to be progressing well. The Committee will examine progress with the transition at its next hearing and will particularly examine the arrangements for cross board membership of the regulatory organisations and other coordination mechanisms.

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64 Evidence p 101.

65 Evidence p 101.

66 Evidence p 103.



2.66 In its report on the RBA's 1995-96 annual report the Committee suggested that there was considerable value in this 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.<sup>67</sup> While a Government response to that recommendation is expected shortly, in his second reading speech on the *APRA Bill 1998* the Treasurer stated that '...Any reports presented to parliament by APRA may, of course, be referred by parliament to a committee, such as the House of Representatives Standing Committee on Financial Institutions and Public Administration, for detailed examination. APRA will also be expected to appear before parliamentary committees on request.'<sup>68</sup> The Committee reiterates the importance of implementing the recommendation from its previous review as a means of formalising the APRA's accountability arrangements.

### Payments system

2.67 One of the major responsibilities of the RBA in its systems stability role is responsibility for the payments system. In fact, the Wallis recommendations increased the RBA's responsibilities in this area so much so that the RBA is getting a new Board to oversee payments system issues.

2.68 The *Financial Sector Reform (Amendments and Transitional Provisions) Bill 1998* amongst other things, establishes the Payments Systems Board within the RBA. The *Payments Systems (Regulation) Bill 1998* was introduced on 26 March 1998 to establish a new regulatory framework for the payments system.

2.69 In a submission the RBA reported that it had restructured its internal operations in preparation for its increased responsibilities in the payments system. It said a new Department has been established '...which will work closely with the Payments System Board on analysis of the economics of the payments system and the formulation and implementation of policies to improve the efficiency and stability of the payments system.'<sup>69</sup>

2.70 For some time the RBA, in association with the banks, has been introducing the real time gross settlement system (RTGS) which is designed to reduce settlement risk. The system involves large payments between each bank being made and confirmed at the same time as each payment instruction is sent.

2.71 The system was expected to commence operating in April this year, but in its February *RTGS industry testing bulletin* the RBA announced that the introduction would be delayed until June after testing revealed unexpected performance problems in the system.<sup>70</sup>

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67 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.

68 Costello, P, Treasurer. Second reading speech, *Australian Prudential Regulation Authority Bill 1998*. *Hansard*, 26 March 1998, p 1160.

69 Evidence p S25.

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

In evidence the RBA advised that the source of the problem was performance problems in the throughput of the Central Site not evident in earlier testing. It said the problems were resolved with migration of payments completed during March and the delays having no long term effect on the RTGS system.<sup>71</sup>

2.72 In early April it was reported that the RBA had announced to the banks that in the light of the pressures the banks face at the end of the financial year, it may be more prudent to delay the live RTGS until early July.<sup>72</sup> The Committee considered that approach very reasonable after the Bank explained that the project is in its final phase and being gradually introduced, with each bank subject to a limit enforced by the system and the limits reduced to zero over a number of weeks. Each reduction is reviewed by the RBA to ensure that it is appropriate to proceed. The Bank reported that if everything runs smoothly it should be possible to introduce the live RTGS in mid June, but for the reasons previously outlined it would be prudent to delay until early July. The RBA said it would announce the live date for RTGS once it had taken into account banks' experience in the first few weeks of the limit reduction period.<sup>73</sup>

2.73 Testing of the new system to reduce cheque clearance from five to three days (ie 48 hours after the day on which the cheque is deposited) is scheduled to commence on 1 July 1998 and is expected to be implemented in July 1999. While Mr Thompson emphasised that the project is the responsibility of the banks themselves, he was able to confirm the project is basically on time for implementation in about April 1999.<sup>74</sup>

### Bank supervision

2.74 In the latter half of 1997 in several conference papers<sup>75</sup> and at the November hearing Mr Thompson noted that the RBA had detected some early signs of declining lending practices by the banks and fired an early warning signal about that trend to try to prevent serious problems emerging. He said that when the matter was raised with the banks they had agreed with the RBA's assessment, even though they believed their bank was not involved.<sup>76</sup> Similar, though less serious, views were expressed by him in the first quarter of 1998.<sup>77</sup>

2.75 At the May hearing Mr Thompson said he was less concerned now about bank lending practices than he was a year ago. He said that perhaps partly in response to his previous comments there was '...evidence of the banks tightening up procedures in a few areas where they looked a bit loose.'<sup>78</sup> He also noted that the particular concern that margins on large

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71 Evidence p S27.

72 Rogers, Ian. Banks given more time for real time system. *Australian Financial Review*, 3 April 1998.

73 Evidence p S27.

74 Evidence p 105.

75 Thompson, GJ, Deputy Governor RBA. September 1997. Banking - The changing scene. Paper presented to *First Pacific Stockbrokers Australasian Banking Conference, Melbourne, 24-26 September 1997*. in: *RBA Bulletin, October 1997*. Sydney, RBA, pp 32-37. and Thompson, GJ, Deputy Governor RBA. October 1997. More on risks in banking. Paper presented to *Australian Institute of Banking and Finance Inc, NSW State Committee, Sydney, 28 October 1997*. in: *RBA Bulletin, November 1997*. Sydney, RBA, pp 50-55.

76 Evidence p 40.

77 Thompson, GJ, Deputy Governor RBA. 1998. Old-fashioned credit risk. *ASX perspective*, 1st Quarter 1998, pp 4-6.

78 Evidence p 98.

corporate loans had now moved to reflect the trend in other parts of the market and that the Bank has no serious concerns about bank asset quality.

2.76 The Committee will continue to monitor this issue.

2.77 A matter of particular interest to the Committee, and the subject of a separate inquiry, is the issue of closure of bank branches. Mr Thompson said Reserve Bank research confirms that the number of bank branches per head of population has continued to decline over the past few years and that there are more branches and other points of representation per head of population outside capital cities than there are within.<sup>79</sup>

2.78 In terms of solutions for regional areas losing branches, he notes that he is:

...not sure what one can do about it, other than to encourage banks to replace full-service branches with alternative forms of access to banking services...and to facilitate, as far as possible, as far as it is within government's control, the provision of services through other...agencies and other financial institutions.<sup>80</sup>

2.79 However, Mr Thompson also stated 'I think if they [banks] want to be seen as good citizens, then it would be in their interests to do so' [ie leave something behind].<sup>81</sup> The Committee strongly agrees. More details on this matter will be presented later this year when the Committee tables its report on regional banking services.

### **"Year 2000 problem"**

2.80 Banks are almost totally dependent on computer systems for their operations and are therefore heavily at risk from the "Year 2000 problem". The RBA reported that the latest estimate of the cost to Australian banks in making themselves Year 2000 compliant is close to \$900 million.<sup>82</sup>

2.81 As well as management of its own systems, the RBA's interest in this problem is as supervisor of banks (at present) and its broader interest in the smooth running of the financial system. In 1997 the Basle Committee on Banking Supervision addressed the Year 2000 risk and recommended a program of remedial action for all banks.<sup>83</sup> The RBA is also on an Inter-bank Working Group on the Year 2000 which includes representatives from commercial banks.<sup>84</sup>

2.82 The macroeconomic effects of the problem in the United States recently were presented by the US Fed to a US Senate Committee.<sup>85</sup> The RBA considers the consequences of not addressing this problem are wide ranging and provided some general comments on this.<sup>86</sup>

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79 Evidence p 100.

80 Evidence p 100.

81 Evidence p 100.

82 Evidence p S25.

83 Thompson, GJ, October 1997, op cit, pp 50-54. and see Evidence p S26.

84 Evidence p S26.

85 Federal Reserve Board. *Testimony of Governor Edward W Kelley, Jr. Before the Committee on Commerce, Science and Transportation, US Senate, 28 April 1998*, 10p.

86 See Evidence pp S25-S26.

2.83 The RBA pointed out that there are three areas to address - its own systems, its connections with others and ensuring that the community understands and is confident the Bank will be ready.<sup>87</sup> Similar issues will need to be addressed by all businesses. In undertaking this task the Bank stressed the importance of a balanced approach. The Deputy Governor, Stephen Grenville, said people need to understand the problem, address it, and address it in good time to fix it while not running any kind of extreme scare tactic which could make the problem worse.<sup>88</sup>

2.84 The importance of contingency arrangements with respect to potential non-compliance of their own systems and also the systems of their suppliers, customers and common infrastructure providers, were emphasised in the RBA submission.<sup>89</sup>

2.85 The Committee supports the strong emphasis the RBA places on community understanding of the "Year 2000 problem" and community confidence that the banking system has appropriately addressed it.

2.86 The RBA is confident its own systems are on track for compliance, especially the new real time gross settlement system which has been designed with that problem in mind, and there will be room for testing.<sup>90</sup>

2.87 In May last year the RBA starting discussing this matter in detail with the banking system. While its 1997 survey revealed progress with the banks was variable, Mr Thompson, expects the results of the Bank's 1998 survey will show that:

...at least in relation to all critical systems - the ones that really have to function well - the banks will be fairly well placed to have those, in the jargon, remediated by around the end of this year, so there will be a good deal of time for testing and contingency planning, if necessary, through 1999...<sup>91</sup>

2.88 Mr Thompson expects a comprehensive assessment of the 1998 survey will be available fairly soon.

2.89 Mr Thompson was also asked for comment on the action taken by other regulators such as the Insurance and Superannuation Commission (ISC) and Australian Financial Institutions Commission (AFIC) in oversighting this problem in their areas of responsibility. He reported that the Year 2000 problem is a significant issue for other financial institutions and has received a good deal of attention from the relevant regulatory agencies. He went on to outline a number of initiatives being undertaken. For example, the ISC is conducting surveys of major superannuation entities and life and general insurance companies as well as activities to raise awareness of the problem. The AFIC and State Supervisory Authorities are amending prudential standards to recognise the problem and promoting awareness of the issue, etc.<sup>92</sup>

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87 Evidence p 95.

88 Evidence p 95.

89 Evidence p S26.

90 Evidence p 95.

91 Evidence p 97.

92 Evidence pp S29-S30.

2.90 He said 'When APRA becomes responsible for regulation of these industries it will carry forward vigorously the work on the Year 2000 problem which the existing agencies have initiated.'<sup>93</sup>

2.91 The Committee will continue to monitor progress in addressing this problem over the next 18 months.

## **Commercial operations**

2.92 In the past there have been criticisms by some banks of the RBA's involvement in commercial activities such as provision of government banking, banking for overseas agencies and securities clearing, registry and settlement services. The RBA maintains that these services are not being cross subsidised by profits from other areas of its activity.

2.93 During 1997 the RBA's commercial activities were reviewed by a Commonwealth Competitive Neutrality Taskforce. The Taskforce was established by the Commonwealth Government to ensure government business activities should not enjoy net competitive advantages over their private sector competitors by virtue of public sector ownership.

2.94 In its *1996-97 annual report* the RBA stated '...it has a clear accounting separation between its commercial [activities] and other activities and that competitive neutrality standards are being met.'<sup>94</sup>

2.95 The Taskforce has now formally reported to Government through its Commonwealth competitive neutrality annual report 1996-97 and the Commonwealth competitive neutrality guidelines for managers.<sup>95</sup> The former sets out the Commonwealth's progress and approach to competitive neutrality and the guidelines provide the detail on how to apply the concept at the agency level. The guidelines state that 'Portfolio Ministers have responsibility for ensuring that CN [competitive neutrality] arrangements are implemented for all commercial business activities within their portfolio...'<sup>96</sup>

2.96 In a submission the RBA updated progress with implementing competitive neutrality principles since its last annual report advising that:

...the Bank has decided to cease its specialised retail currency distribution business which will henceforth be undertaken by the private sector. The transition is currently underway. A taskforce has been established to oversee the change in status of Note Printing Australia from an autonomous division of the Bank to a fully owned subsidiary company.<sup>97</sup>

2.97 The Committee will follow up progress with that taskforce and other changes in the Bank's commercial operations at the November 1998 hearing.

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93 Evidence p S30.

94 *Reserve Bank of Australia report and financial statements 1997*, op cit, p 39.

95 *Commonwealth competitive neutrality annual report 1996-97*. 1997. Canberra, AGPS, iii 19p; *Commonwealth competitive neutrality guidelines for managers*. 1998. Canberra, AGPS, iv 38p.

96 *Commonwealth competitive neutrality guidelines for managers*, op cit, p 5.

97 Evidence p S28.

## Central bank cooperation

2.98 The Bank reported that the Executive Meeting of eleven East Asian and Pacific central banks - EMEAP - continued to provide a useful forum for central bankers in the region to discuss issues of common interest. The Bank reiterated the facilitative role of EMEAP in achieving the rapid response of regional economies to the IMF-led rescue packages for Thailand, Indonesia and South Korea, and outlined EMEAP's meetings since the November 1997 hearing.<sup>98</sup> The Committee again praises and encourages the Bank's role in this important regional forum.

David Hawker MP  
Chairman  
4 June 1998

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98 Evidence p S28.

## Minority Report from Mr G Wilton MP and Mr M Latham MP

### Add after paragraph 2.19

The Committee believes it is important to test these assertions against the historical record. The following points can be made:

- Official forecasts point to the maintenance of domestic demand – adding to the problem of an import / export imbalance. As the RBA itself records in its Semi-Annual Statement to the Committee:

The general pick-up in momentum [in the latter part of 1997] reflected stronger growth in most components of private demand, with strength particularly evident in consumer spending and housing construction...

Early indications are that domestic demand has maintained momentum in the early part of 1998...<sup>1</sup>

Moreover, the recent Federal Budget forecasts private final demand averaging 5% through 1998-99, with GNE at 4.75%. With GDP growth forecast at 3%, this represents a significant domestic imbalance.

- The CAD problem in the mid-1980s was also a product of external shock. As the Treasury records in Budget Paper No. 1:

...the contribution of external factors to the rise in the current account deficit was dominant in the mid-1980s episode, with a large decline in the terms of trade and much slower growth in exports leading to a fall in domestic saving relative to investment and hence a deterioration in the trade balance...<sup>2</sup>

History does not appear to be on the RBA's side in arguing that, this time, interest rates will not rise due to difficulties on the current account.

- In the late 1980s Australia ran a Federal Budget surplus at 2% GDP (significantly higher than the 1998/99 forecast). Yet at this time the nation encountered a CAD of more than 6% GDP – leading most commentators to question the application of the twin deficits theory. Again, strong similarities exist in previous CAD blow-outs and the current circumstances.
- Indeed, the Australian fundamentals have not altered with regard to our chronic current account problem. While there are few, if any, laws in economics, the following seems indisputable: a small trading nation with poor national savings cannot grow faster than its trading partners without an undesirable spill-over onto the external account. In this respect, Australia's circumstances seem little different from the CAD problems in each of the mid-1980s, late 1980s and mid-1990s. The Governor acknowledged, with regard to

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1 Reserve Bank of Australia. May 1998. *Semi-annual statement on monetary policy, May 1998*. Sydney, RBA, p 14.

2 *Budget strategy and outlook 1998-99. Budget Paper No. 1*. Canberra, AGPS, p 3-6.

national savings, that '...It is a policy failure of every Australian government we have had in the last 20 years...'<sup>3</sup>

- Certainly, Australia's national savings policies and performance have been disappointing in recent years. Improvements in public sector savings have been at the expense of private savings – including \$5 billion in fiscal drag and significant cuts to essential services in health, education and child care. Private savings have fallen as many households have been forced to pay for higher tax liabilities and higher user charges from household savings. The 1998/99 Budget forecasts a significant drop in the household savings ratio: from 4.7% in 1996/97 to 2.75% in 1998/99 – one of the lowest ratios of any nation in the Western world. Moreover, the abandonment of the previous Government's plan for employee contributions in superannuation (with a public co-payment) and its replacement with a 15% savings tax rebate, seems likely to produce weaker private and national savings. These trends are confirmed by the chart at page 1-12 of Budget Paper No. 1<sup>4</sup>. It shows a decrease in national savings since 1996 – with the rate anchored well below 20% of GDP.
- With the RBA now expecting recessions in several South-East Asian economies, plus sluggish growth in Japan, Australia's outlook appears poor. If we grow faster than our Asian trading partners then the CAD will emerge as a restraint; if we slow the economy in response to the CAD then unemployment will rise through the medium term.

Delete paragraph 2.30.

Paragraph 2.31 - delete the last sentence and add the following clause:

The Committee notes media reports that the Department of Treasury did not agree with Australia's 'counterweight' policy. To overcome its capital account problem and the lack of confidence on international markets, Indonesia needs to develop a modern financial system with proper prudential supervision. Equally, it is in Australia's best interests to see a further reduction in tariffs and import quotas in Indonesia. In evidence the Governor pointed to the way in which economic liberalisation '...took decades to occur in this country, took decades to occur in a number of other countries...'<sup>5</sup> It is valid to point out, however, that Australia has never had the type of difficulties that plague Indonesian markets. In these circumstances, Australia's national interests may have been better served by a more active reform timetable, subject to humanitarian concerns and linked to our \$1 billion contribution to the IMF credit package. Certainly, recent events have not delivered on the promise of the 'counterweight' policy for political stability in Indonesia.

Mr G Wilton MP  
4 June 1998

Mr M Latham MP

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3 Evidence p 84.

4 *Budget strategy and outlook 1998-99*, op cit, p 1-12.

5 Evidence p 90.



## **APPENDIX 1**

### **LIST OF SUBMISSIONS**

- 1 Reserve Bank of Australia (Small business lending)
- 2 Reserve Bank of Australia (Aspects of small business finance)
- 3 Reserve Bank of Australia (Executive earnings and their contribution to aggregate wages growth)
- 4 Reserve Bank of Australia
- 5 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

#### **Melbourne, Thursday 7 May 1998**

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)

#### **Wednesday 6 May 1998**

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

Mr Barry Hughes, Chief Economist, CS First Boston



## **COMMITTEE'S REVIEWS OF ANNUAL REPORTS**

### **38TH PARLIAMENT**

*Review of the Reserve Bank of Australia annual report 1996-97: Interim report.*  
(Tabled 23 March 1998)

*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)

